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STATE TAXATION OF INTERSTATE COMMERCE AND WORLDWIDE CORPORATE INCOME

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 983

A BILL TO REGULATE AND FOSTER COMMERCE AMONG THE STATES BY PROVIDING A SYSTEM FOR THE TAXATION OF INTERSTATE COMMERCE

S. 1688

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CLARIFY THE EXTENT TO WHICH A STATE, OR POLITICAL SUBDIVISION, MAY TAX CERTAIN INCOME FROM SOURCES OUTSIDE THE UNITED STATES

JUNE 24, 1980

PART 1 OF 2 PARTS
(Oral Testimony)

Printed for the use of the Committee on Finance

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STATE TAXATION OF INTERSTATE COMMERCE AND WORLDWIDE CORPORATE INCOME

TUESDAY, JUNE 24, 1980

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Baucus, Dole, Packwood, and Wallop.

[The press release announcing this hearing and the bills S. 983 and S. 1688 follow:]

Press Release #H-31

PRESS RELEASE

FOR IMMEDIATE RELEASE
June 6, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON S. 983 AND S. 1688

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on Tuesday, June 24, 1980, on two tax bills.

The hearing will begin at 9:00 A.M. in Room 2221 of the Dirksen Senate Office Building.

S. 983 -- Introduced by Senator Mathias. This bill would establish national standards governing state taxation of interstate commerce and rules governing state taxation of worldwide corporate income. It also establishes jurisdiction of the United States Court of Claims for resolution of disputes arising under the Act.

S. 1688 -- Introduced by Senator Mathias. This bill would limit States and political subdivisions from applying the combined method of reporting to determine the worldwide income of businesses operating within their jurisdictions.

Witnesses who desire to testify at the hearing must submit a written request, including a mailing address and phone number, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510, by no later than the close of business on June 18, 1980.

Consolidated Testimony. -- Senator Byrd also stated that the Committee urges all witnesses who have a common position or with the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain. The Chairman urged very strongly that all witnesses exert a maximum effort, taking into account the limited advance notice, to consolidate and coordinate their statements.

Legislative Reorganization Act. -- Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their oral presentations to a summary of the points included in the statement.

Written statements. -- Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D. C. 20510, not later than July 11, 1980.

II

96TH CONGRESS
1ST SESSION

S. 983

To regulate and foster commerce among the States by providing a system for the taxation of interstate commerce.

IN THE SENATE OF THE UNITED STATES

APRIL 23 (legislative day, APRIL 9), 1979

Mr. MATHIAS introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To regulate and foster commerce among the States by providing a system for the taxation of interstate commerce.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Interstate Taxation Act of 1979".

TITLE I—SALES AND USE TAXES

PART A—JURISDICTION AND ADMINISTRATION

SEC. 101. UNIFORM JURISDICTIONAL STANDARDS.

(a) STATE STANDARD.—No State shall have power to require a person to collect a sales or use tax with respect to a sale or use of tangible personal property unless that person—

(1) has a business location in that State, or

(2) regularly solicits orders for the sale of tangible personal property by means of salesmen, solicitors, or representatives in that State, unless his activity in that State consists solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or television, or

(3) regularly engages in the delivery of tangible personal property in that State other than by common carrier or United States Postal Service.

(b) POLITICAL SUBDIVISION STANDARD.—No political subdivision of a State shall have power to require a person to collect a sales or use tax with respect to a sale or use of tangible personal property unless that person—

(1) has a business location in that political subdivision, or

(2) regularly solicits orders for the sale of tangible personal property by means of salesmen, solicitors, or representatives in that political subdivision, unless his

activity in that political subdivision consists solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or television, or

(3) regularly engages in the delivery of tangible personal property in that political subdivision other than by common carrier or United States Postal Service.

(c) FREIGHT CHARGES INCIDENT TO INTERSTATE SALES.—Where the freight and other charges for transporting tangible personal property to a purchaser incident to an interstate sale are not included in the purchase price but are stated separately by the seller, no State or political subdivision thereof shall have power to include such charges in the measure of a sales or use tax imposed with respect to the sale or use of such property.

SEC. 102. REDUCTION OF MULTIPLE TAXATION.

(a) DESTINATION IN STATE; COOPERATIVE AGREEMENTS BETWEEN STATES.—A State may impose a sales tax or require a seller to collect a sales or use tax with respect to an interstate sale of tangible personal property only if the destination of the sale is—

(1) in that State, or

(2) in a State or political subdivision for which the tax is required to be collected by an agreement between the State of destination and the State requiring

such collection, and the seller has a business location in the State requiring such collection.

(b) Destination in Political Subdivision.—A political subdivision of a State may impose a sales tax or require a seller to collect a sales or use tax with respect to an interstate sale of tangible personal property only if the destination of the sale is in that political subdivision.

(c) Limitation.—Notwithstanding section 101 and subsections (a) and (b) of this section, no State or political subdivision thereof shall have power to require an out-of-State seller to collect a sales or use tax with respect to an interstate sale of tangible personal property with a destination in that State if such seller's annual receipts from taxable retail sales of tangible personal property with a destination in that State are less than $20,000, except that this limitation shall not be effective to the extent that such seller has, in fact, collected a separately stated sales or use tax from the purchaser. In determining whether the foregoing limitation applies, an out-of-State seller shall be deemed to have less than $20,000 in annual receipts from taxable retail sales of tangible personal property with a destination in a State if such seller's receipts from such sales during the preceding calendar year did not exceed $20,000.

(d) Credit for Prior Taxes.—The amount of any use tax imposed by a State or political subdivision thereof with respect to tangible personal property shall be reduced by the amount of any sales or use tax previously paid by the taxpayer with respect to the same property on account of liability to another State or political subdivision thereof.

(e) Refunds.—A person who pays a use tax imposed with respect to tangible personal property shall be entitled to a refund from the State or political subdivision thereof imposing the tax, up to the amount of the tax so paid, for any sales or use tax subsequently paid to the seller with respect to the same property on account of prior liability to another State or political subdivision thereof.

(f) Vehicles, Boats and Motor Fuels.—

(1) Vehicles and boats.—Nothing in subsection (a) or (b) shall affect the power of a State or political subdivision thereof to impose or require the collection of a sales or use tax with respect to motor vehicles and boats registered in that State.

(2) Fuels.—Nothing in this section shall affect the power of a State or political subdivision thereof to impose or require the collection of a sales or use tax with respect to motor fuels consumed in that State.

SEC. 103. SALES TO REGISTERED BUSINESS PURCHASER; EXEMPT SALES CERTIFIED AS SUCH BY PURCHASER.

No seller shall be liable for the collection or payment of a sales or use tax with respect to an interstate sale of tangible personal property if the purchaser of such property furnishes or has furnished to the seller—

(1) a statement indicating that the purchaser is registered with the jurisdiction imposing the tax to collect or pay such tax, or

(2) a certificate or other form of evidence indicating the basis for exemption or other reason the seller is not required to collect or pay such tax.

Any statement, certificate, or other form of evidence furnished for purposes of paragraph (1) or (2) shall be in writing, shall give the name and address of the purchaser and his registration number, if any, and shall be signed by the purchaser or his representative. Nothing in this section shall limit the liability of a seller who, at the time of receipt of a statement, certificate, or other form of evidence furnished by a purchaser for purposes of paragraph (1) or (2), has actual knowledge that such document is false or inaccurate.

SEC. 104. SALES BY CERTAIN OUT-OF-STATE SELLERS.

(a) Election To Collect Tax Certified by Purchaser.—With respect to any calendar year, an out-of-State seller who has less than $100,000 annually in taxable sales of tangible personal property with a destination in a State may, in lieu of collecting any sales or use tax which that State or a political subdivision thereof may require to be collected under sections 101 and 102, elect to collect and remit to that State a combined State and local sales or use tax at a rate or in an amount which shall be certified to such seller by the purchaser as being the correct rate or amount applicable to the sale. Any such certification shall be in writing, shall give the name and address of the purchaser and his registration number, if any, and shall be signed by the purchaser or his representative. Nothing in this section shall limit the liability of an out-of-State seller who has made an election under this subsection and who, at the time of receipt of a purchaser's certification of the correct rate or amount tax applicable to an interstate sale with a destination in a State to which such election applies, has actual knowledge that such certification is false or inaccurate.

(b) FAILURE OF PURCHASER TO CERTIFY CORRECT RATE OR AMOUNT OF TAX.—If an election under subsection (a) is in effect with respect to a State, and a purchaser in that State who purchases tangible personal property from the electing out-of-State seller fails or refuses to certify to such seller the correct rate or amount of sales or use tax applicable to the sale, such seller shall collect and remit the highest combined State and local sales or use tax which could be imposed with respect to any interstate sale having a destination in that State and shall in no way be liable to such purchaser for any excess of the tax so collected over the correct amount of tax applicable to the sale.

(c) DETERMINATION OF ANNUAL TAXABLE SALES IN A STATE.—For purposes of determining whether an out-of-State seller is eligible to make an election under subsection (a) with respect to any calendar year, such seller shall be deemed to have less than $100,000 annually in taxable sales of tangible personal property with a destination in a State if such seller's receipts from such sales during the preceding calendar year did not exceed $100,000.

(d) ADMINISTRATION.—No State may require an out-of-State seller who elects under subsection (a) to collect combined State and local sales and use taxes pursuant to purchasers' certifications of the correct rates or amounts of such taxes to remit the taxes so collected more frequently than once each calendar quarter. A State may require such a seller to maintain such records, certifications, and other information as may be necessary for the proper administration of such taxes, but may not require such a seller to classify or otherwise account for the sales to which such taxes relate according to geographic areas of that State in any manner whatsoever, including classification by political subdivision.

(e) **Standard Form of Return.**—The Secretary of Commerce of the United States shall prescribe a standard form of return for the combined State and local sales and use taxes collected by an out-of-State seller who has made an election under subsection (a), and no State or political subdivision thereof may require such seller to file, with respect to such taxes, a form of return other than such standard form. The filing of a certified duplicate copy of such standard form incorporating the information required for all States with respect to which such seller has made an election under subsection (a) shall be accepted in lieu of the filing of a separate return for each such State.

SEC. 105. ACCOUNTING FOR LOCAL TAXES.

No seller shall be required by a State or political subdivision thereof to classify interstate sales for sales or use tax accounting purposes according to geographic areas of that State in any manner other than to account for interstate sales with destinations in political subdivisions in which the seller has a business location or regularly makes household deliveries.

SEC. 106. SAVINGS PROVISIONS.

(a) **Use Taxes.**—Nothing in this Act shall prohibit a State or political subdivision thereof from imposing and collecting a use tax from a purchaser or user with respect to the use in that State or political subdivision of tangible personal property—

(1) acquired in an interstate sale from an out-of-State seller who is not required to collect such a tax with respect to such sale, or

(2) acquired outside that State or political subdivision and brought into that State or political subdivision by such purchaser or user.

(b) CORRECT TAX NOT COLLECTED.—Nothing in this Act shall prohibit a State or political subdivision thereof from collecting a sales or use tax from a person who purchases tangible personal property in an interstate sale if for any reason, including an incorrect or invalid certification or representation made by such purchaser with respect to the tax-exempt status of such sale or, in the case of a purchase from an out-of-State seller having made an election under section 104(a), with respect to the correct rate or amount of tax applicable to such sale, the seller has not collected the correct amount of sales or use tax from such purchaser. This subsection shall not apply if the seller has collected the correct amount of tax from the purchaser but has failed to remit such tax to the State.

(c) CERTAIN ADVANCE PAYMENTS.—Nothing in this Act shall prohibit a State or political subdivision thereof from requiring a purchaser of tangible personal property for resale to make an advance payment of a sales or use tax to the seller of such property, or from requiring such seller to act as agent for such State or political subdivision and in that capacity to collect and remit such advance payment: *Provided,* That credit for such advance payment is allowed in determining the sales or use tax liability of the purchaser and provided that all the foregoing requirements are imposed pursuant to laws of such State or political subdivision which were in effect on December 31, 1974.

SEC. 107. LIABILITY WITH RESPECT TO UNASSESSED TAXES.

(a) Periods Ending Prior to Enactment Date.—No State or political subdivision thereof shall have the power, after the date of the enactment of this Act, to assess against any person for any period ending on or before such date in or for which that person became liable for the tax involved, a sales or use tax with respect to tangible personal property, unless during such period that person—

(1) had a business location in that State, or

(2) regularly solicited orders for the sale of tangible personal property by means of employees present in that State, unless his activity in that State consisted solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or television, or

(3) regularly engaged in the delivery of tangible personal property in that State other than by common carrier or United States Postal Service.

(b) CERTAIN PRIOR ASSESSMENTS AND COLLECTIONS.—The provisions of subsection (a) shall not be construed—

(1) to invalidate the collection of a tax prior to the time assessment became barred under subsection (a), or

(2) to prohibit the collection of a tax at or after the time assessment became barred under subsection (a), if the tax was assessed prior to such time.

PART B—DEFINITIONS AND RULES

SEC. 151. SALES TAX; SALE; SALES PRICE.

A "sales tax" is any tax imposed with respect to, and measured by the sales price of, the sale of tangible personal property or services with respect to such a sale, and which tax is required by State law to be stated separately from the sales price by the seller or is customarily stated separately from the sales price. The term "sale" includes any lease or rental of tangible personal property and the term "sales price" includes receipts from any such lease or rental.

SEC. 152. USE TAX.

A "use tax" is any nonrecurring tax, other than a sales tax, which is imposed on or with respect to the exercise or enjoyment of any right or power over tangible personal property incident to the ownership of that property or the leasing of that property from another, including any consumption, keeping, retention, or other use of tangible personal property.

SEC. 153. INTERSTATE SALE.

An "interstate sale" means a sale in which the tangible personal property sold is shipped or delivered to the purchaser in a State from a point outside that State.

SEC. 154. STATE.

The term "State" wherever used in this Act means the District of Columbia or any of the fifty States of the United States.

SEC. 155. DESTINATION.

The "destination" of a sale is in the State or political subdivision in which possession of the property is physically transferred to the purchaser, or to which the property is shipped to the purchaser regardless of the free on board point or other conditions of the sale.

SEC. 156. OUT-OF-STATE SELLER.

An "out-of-State seller" with respect to any State is a seller who does not have a business location in that State.

SEC. 157. BUSINESS LOCATION.

A person shall be considered to have a "business location" within a State only if that person—

(1) owns or leases real property within that State, or

(2) has one or more employees located in that State, or

(3) regularly maintains a stock of tangible personal property in that State for sale in the ordinary course of his business.

For purposes of paragraph (3), property which is on consignment in the hands of a consignee and is offered for sale by such consignee shall not be considered as stock maintained by the consignor, and property which is in the hands of a purchaser under a sale or return arrangement shall not be considered as stock maintained by the seller.

SEC. 158. LOCATION OF PROPERTY.

Property shall be considered to be located in a State if it is physically present in that State.

SEC. 159. LOCATION OF EMPLOYEE.

(a) GENERAL RULE.—An employee shall be considered to be located in a State if—

(1) the service of such employee is localized in that State, or

(2) the service of such employee is not localized in any State but some of such service is performed in that State and such employee's base of operations is in that State.

(b) LOCALIZATION OF SERVICE.—An employee's service shall be considered to be localized in a State if—

(1) such service is performed entirely within that State, or

(2) such service is performed both within and without that State, but the service performed without that State is incidental to the service performed within that State.

(c) BASE OF OPERATIONS.—An employee's base of operations is that single place of business, having a permanent location, which is maintained by his employer, and from which he regularly commences his activities and to which he regularly returns in order to perform the functions necessary to the exercise of his trade or profession.

(d) CONTINUATION OF MINIMUM JURISDICTIONAL STANDARD.—An employee shall not be considered to be located in a State if his business activities within that State on behalf of his employer are limited to any one or more of the following:

(1) The solicitation of orders for sales of tangible personal property, which orders are sent outside that State for approval or rejection and (if approved) are filled by shipment or delivery from a point outside the State.

(2) The solicitation of orders for sales of or for the benefit of a prospective customer of his employer, if orders by such customer to such employer to enable

such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(3) The installing or repairing of tangible personal property which is the subject of an interstate sale by the employer, if such installation or repair is incidental to the sale.

This subsection shall not apply with respect to business activities carried on by one or more employees within a State if the employer (without regard to those employees) has a business location in that State.

(e) EMPLOYEES OF CONTRACTORS AND EXTRACTORS.—If the employer is engaged in the performance of a contract for the construction of improvements on or to real property in a State or of a contract for the extraction of natural resources located in a State, an employee whose services in that State are related primarily to the performance of such contract shall be presumed to be located in that State. This subsection shall not apply with respect to services performed in installing or repairing tangible property which is the subject of an interstate sale by the employer, if such installation or repair is incidental to the sale.

(f) EMPLOYEE.—No person shall be considered an employee of an employer unless such person is an employee of such employer for purposes of Federal income tax withholding under chapter 24 of the Internal Revenue Code of 1954, as amended.

SEC. 160. HOUSEHOLD DELIVERIES.

A seller makes household deliveries in a State or political subdivision if he delivers goods, otherwise than by common carrier or United States Postal Service, to the dwelling place of his purchasers located in that State or political subdivision.

SEC. 161. LIMITATION ON APPLICABILITY.

Except as otherwise expressly provided in this Act, the definitions and rules set forth in this part shall apply only for purposes of this title.

TITLE II—GROSS RECEIPTS TAXES

PART A—JURISDICTION

SEC. 201. UNIFORM JURISDICTIONAL STANDARD.

No State or political subdivision thereof shall have power to impose a gross receipts tax with respect to the interstate sale of tangible personal property unless the sale is solicited directly through a business office of the seller in the State or political subdivision.

SEC. 202. SAVINGS PROVISION.

Nothing in this Act shall prohibit a State or political subdivision thereof from imposing and collecting a gross receipts tax on activities occurring entirely within that State or political subdivision, including any tax imposed with respect to the extraction of oil, coal, minerals, or other natural resources located within that State or political subdivision.

PART B—DEFINITIONS

SEC. 251. GROSS RECEIPTS TAX.

For purposes of this title, a "gross receipts tax" is any tax, other than a sales tax, which is imposed on or measured by the gross volume of business (whether in terms of gross receipts or in other terms), which is applicable to commercial or manufacturing business in general, and in the determination of which no deduction is allowed which would constitute the tax a net income tax.

SEC. 252. BUSINESS OFFICE.

For purposes of this title, a seller shall be considered to have a "business office" in a State or political subdivision only if that seller—

(1) owns or leases real property within that State or political subdivision, or

(2) regularly maintains a stock of tangible personal property in that State or political subdivision for sale in the ordinary course of his business.

For purposes of paragraph (1), a seller shall not be considered as owning or leasing real property which is owned or leased by that seller's employee, unless that seller pays the costs of owning or leasing such property. For purposes of paragraph (2), property which is on consignment in the hands of a consignee and is offered for sale by such consignee on his own account shall not be considered as stock maintained by the consignor, and property which is in the hands of a purchaser under a sale or return arrangement shall not be considered as stock maintained by the seller.

SEC. 253. OTHER DEFINITIONS.

For purposes of this title, the terms "sales tax", "State", and "interstate sale" have the same meaning as such terms have for purposes of title I of this Act, and the term "net income tax" has the same meaning as such term has for purposes of title III of this Act.

TITLE III—NET INCOME TAXES

PART A—APPORTIONABLE AND ALLOCABLE INCOME

SEC. 301. OPTIONAL THREE-FACTOR FORMULA.

A State or political subdivision thereof may not impose for any taxable year on a corporation taxable in more than one State, other than an excluded corporation, a net income tax measured by an amount of net income in excess of the amount determined by (1) multiplying the corporation's base by an apportionment fraction which is the average of the corporation's equally weighted property, payroll and sales factors for that State for the taxable year and (2) adding to the amount determined under clause (1) the amount of income allocable to that State for the taxable year. For this purpose the base to which the apportionment fraction is applied shall be the corporation's apportionable income as defined in this title for that taxable year. No State shall, by reason of not including dividends or foreign source income in apportionable income, make any offsetting adjustment of an otherwise allowable deduction which is unrelated to such excluded dividends or foreign source income.

SEC. 302. INCOME ALLOCABLE TO A STATE; EXCLUSIONS FROM APPORTIONABLE AND ALLOCABLE INCOME.

Dividends received from corporations in which the taxpaying corporation owns less than 50 percent of the voting stock, other than dividends which constitute foreign source income, are income allocable to the State of commercial domicile of such taxpaying corporation and are not apportionable or allocable to any other State. No dividends received from corporations in which the taxpaying corporation owns 50 percent or more of the voting stock and no foreign source income of such taxpaying corporation shall be apportionable or allocable to any State.

SEC. 303. COMBINED OR CONSOLIDATED REPORTING.

(a) Except as otherwise provided in subsection (b), a State may require, or a corporation may elect, that the taxable income of the corporation be determined by reference to the combined or consolidated net income and the combined or consolidated apportionment factors of all affiliated corporations in the affiliated group of which the corporation is a member.

(b) For purposes of subsection (a), no State may require, and no corporation may elect, that a combination or consolidation of an affiliated group include—

(1) any excluded corporation, or

(2) any corporation, substantially all the income of which is derived from sources without the United States.

For purposes of paragraph (2), substantially all the income of a corporation (whether a domestic or a foreign corporation) shall be deemed to be derived from sources without the United States if 80 percent or more of its gross income is derived from sources without the United States in the current taxable year and in each of the 2 preceding taxable years (excluding any period during which such corporation was not in existence).

(c) Nothing in this title shall preclude the determination of combined or consolidated income on a basis acceptable to both the State and the taxpaying corporation.

PART B—DEFINITIONS AND RULES

SEC. 351. NET INCOME TAX.

A "net income tax" is a tax which is imposed on or measured by net income.

SEC. 352. EXCLUDED CORPORATION.

An "excluded corporation" is any of the following:

(1) Any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, small loan association, credit union, cooperative bank, small loan company, sales finance company, or investment company, or any type of insurance company, or any corporation which derives 90 percent or more of its gross income from interest (including discount).

(2) Any corporation more than 50 percent of the ordinary gross income of which for the taxable year is derived from regularly carrying on any one or more of the following business activities:

(A) the transportation for hire of property or passengers, including the rendering by the transporter of services incidental to such transportation;

(B) the sale of electrical energy or water; or

(C) the furnishing of public telegraph or intrastate telephone services.

SEC. 353. AFFILIATED CORPORATIONS.

Two or more corporations are "affiliated" if they are members of the same group comprised of one or more corporate members connected through stock ownership with a common owner, which may be either corporate or noncorporate, in the following manner:

(1) more than 50 percent of the voting stock of each member other than the common owner is owned directly by one or more of the other members; and

(2) more than 50 percent of the voting stock of at least one of the members other than the common owner is owned directly by the common owner.

SEC. 354. APPORTIONABLE INCOME.

Except to the extent otherwise provided in section 301 or section 302, the "apportionable income" of a corporation means its net income subject to apportionment as determined under the laws of the taxing State.

SEC. 355. PROPERTY FACTOR.

(a) IN GENERAL.—A corporation's property factor for any State is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located in that State and the denominator of which is the average value of all the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located everywhere, except that such denominator shall not include any property which the State or the corporation determines to exclude pursuant to section 358(c).

(b) STANDARDS FOR VALUING PROPERTY IN PROPERTY FACTOR.—

(1) OWNED PROPERTY.—Property owned by the corporation shall be valued at its original cost.

(2) RENTED PROPERTY.—Property rented to the corporation shall be valued at eight times the net rents payable by the corporation during the taxable year. Net rent is the gross rent payable by the corporation less rent received by the corporation from subrentals.

SEC. 356. PAYROLL FACTOR.

(a) IN GENERAL.—A corporation's payroll factor for a State is a fraction, the numerator of which is the amount of wages paid or accrued during the taxable year by the corporation to employees located in that State and the denominator of which is the total amount of wages paid or accrued during the taxable year by the corporation to all employees located everywhere, except that such denominator shall not include any wages which the State or the corporation determines to exclude pursuant to section 358(c).

(b) DEFINITION OF WAGES.—The term "wages" means wages as defined for purposes of the Federal Unemployment Tax Act in section 3306(b) of the Internal Revenue Code of 1954, as amended, determined without regard to the limitation of section 3306(b)(1) on the amount of wages.

SEC. 357. SALES FACTOR.

(a) In General.—A corporation's sales factor for a State is a fraction, the numerator of which is the total sales of the corporation in that State during the taxable year and the denominator of which is the total sales of the corporation everywhere during the taxable year, except that such denominator shall not include any sales which the State or the corporation determines to exclude pursuant to section 358(c).

(b) Sales Included.—

(1) Sales of tangible personal property are in a State if such property is received in that State by the purchaser. In the case of delivery by common carrier or by other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered as the place at which such property is received by the purchaser. Direct delivery in a State, other than for purposes of transportation, to a person or firm designated by a purchaser constitutes delivery to the purchaser in that State and direct delivery outside a State to a person or firm designated by a purchaser does not constitute delivery to the purchaser in that State, regardless of where title passes or other conditions of sale.

(2) Sales, other than sales of tangible property, are in a State if—

(A) the income-producing activity is performed in that State, or

(B) the income-producing activity is performed both in and outside that State and a greater proportion of the income-producing activity is performed in that State than in any other State, based on costs of performance.

(c) LOCATION OF CERTAIN OTHER SALES.—

(1) Sales of services shall be included in the numerator of the sales factor for the State in which the service is performed. Sales of services rendered in two or more states shall, for the purpose of the numerator of the sales factor, be divided between those States in proportion to the direct costs of performance incurred in each such State by the corporation in rendering the services.

(2) Sales of real property, if the corporation is engaged primarily in the business of selling real property, are included in the numerator of the sales factor for the state in which the property is located.

(3) Sales which consist of receipts from the rental of tangible personal property shall be included in the numerator of the sales factor for the State in which the property is located.

(d) All Other Sales.—All gross receipts from sales, other than from sales described in subsections (b) and (c), shall be excluded from both the numerator and the denominator of the sales factor.

SEC. 358. FOREIGN SOURCE INCOME.

(a) Definition.—The term "foreign source income" means—

(1) interest other than interest derived from sources within the United States;

(2) dividends other than dividends derived from sources within the United States;

(3) rents, royalties, license, and technical fees from property located or services performed without the United States or from any interest in such property, including rents, royalties, or fees for the use of or the privilege of using without the United States any patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties; and

(4) gains, profits, or other income from the sale of intangible or real property located without the United States.

(b) Determination of Source of Income by Reference to Provisions of the Internal Revenue Code of 1954.—In determining the source of income for purposes of this section and section 303(b), the provisions of sections 861, 862, and 863 of the Internal Revenue Code of 1954, as amended, shall be applied.

(c) ADJUSTMENT OF PROPERTY, PAYROLL, OR SALES FACTORS.—If foreign source income as defined for purposes of this title is derived from property, wages or sales which are otherwise includable in the denominator of a factor described in section 355, 356, or 357, either the State or the corporation may determine that the property, wages, or sales from which such foreign source income is derived shall be excluded from such denominator.

SEC. 359. DIVIDENDS.

The term "dividends" shall have the same meaning as that term has under the Internal Revenue Code of 1954, as amended, including any sum treated as a dividend under section 78 of such Code.

SEC. 360. UNITED STATES.

The term "United States" wherever used in this Act shall include only the fifty States and the District of Columbia.

SEC. 361. LIMITATION ON APPLICABILITY.

Except as otherwise expressly provided in this Act, the definitions and rules set forth in this part shall apply only for purposes of this title.

TITLE IV—JURISDICTION OF FEDERAL COURTS

SEC. 401. JUDICIAL REVIEW.

Notwithstanding section 1251(a) of title 28, United States Code, the United States Court of Claims shall have jurisdiction to review de novo any issues relating to a dispute arising under this Act or under the provisions of Public Law 86–272, as amended. Within 90 days of the decision of a State administrative body from which the only appeal is to a court, any party to the determination may petition the Court of Claims for a review de novo of any such issues. For purposes of such review, the findings of fact by the State administrative body shall be considered with other evidence of the facts. The judgment of the Court of Claims shall be subject to review by the Supreme Court of the United States as provided in section 1255 of title 28, United States Code, as amended.

SEC. 402. EFFECT OF FEDERAL DETERMINATION.

Any judicial determination made pursuant to section 401 shall be binding for the taxable years involved on any State given notice thereof or appearing as a party thereto, notwithstanding any prior determinations of the courts or administrative bodies of that State completed after notice to that State. No statute of limitations shall bar the right of a State or a taxpayer to an amount of tax increased or decreased in accordance with such determination, provided action to recover such amount is instituted within one year after such determination has become final.

SEC. 403. CONFORMING AMENDMENT TO TITLE 28, UNITED STATES CODE.

Title 28, United States Code, is hereby amended by adding after section 1507 the following new section:

"§ 1508. Jurisdiction to review certain disputes involving State taxation of interstate commerce

"The Court of Claims shall have jurisidiction to render judgment upon any petition for review under section 401 of the Interstate Taxation Act of 1979."

TITLE V—MISCELLANEOUS PROVISIONS

SEC. 501. PROHIBITION AGAINST OUT-OF-STATE AUDIT CHARGES.

No charge may be imposed by a State or political subdivision thereof to cover any part of the cost of conducting outside that State an audit for a tax to which this Act applies.

○

96TH CONGRESS
1ST SESSION

S. 1688

To amend the Internal Revenue Code of 1954 to clarify the extent to which a State, or political subdivision, may tax certain income from sources outside the United States.

IN THE SENATE OF THE UNITED STATES

AUGUST 3 (legislative day, JUNE 21), 1979

Mr. MATHIAS (for himself, Mr. HUDDLESTON, and Mr. WALLOP) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to clarify the extent to which a State, or political subdivision, may tax certain income from sources outside the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) chapter 77 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 7518. INCOME OF CORPORATIONS ATTRIBUTABLE TO FOREIGN CORPORATIONS.

"(a) IN GENERAL.—For purposes of imposing an income tax on any corporation, no State, or political subdivision thereof, may take into account, or include in income subject to such tax, any amount of income of, or attributable to, any foreign corporation which is a member of any affiliated group of corporations which includes both such corporations unless such amount is includable in the gross income of such corporation for purposes of chapter 1 (including any amount includable in gross income under subpart F of part III of subchapter N of chapter 1) for the taxable year in which or with which the taxable period (for purposes of State or local law) ends.

"(b) INCOME TAX DEFINED.—For purposes of this section, the term, 'income tax' means any tax which is imposed on, according to, or measured by income.

"(c) AFFILIATED GROUP DEFINED.—For purposes of subsection (a), the term 'affiliated group' means a common parent corporation and one or more chains of corporations connected through stock ownership with such common parent corporation.

"(d) CERTAIN CORPORATIONS TREATED AS FOREIGN CORPORATIONS.—For the purpose of this section, a domestic corporation shall be treated as a foreign corporation if under section 861(a)(2)(A) a dividend received from such corporation in the taxable year referred to in subsection (a) would not be treated as income from sources within the United States.

"(e) CERTAIN DIVIDENDS PAID OR DEEMED PAID.—

"(1) DIVIDENDS EXCLUDED FROM TAX.—If a corporation receives in any taxable year a dividend from a foreign corporation (or is by application of section 951 treated as having received such a dividend), in imposing an income tax on such corporation no State, or political subdivision thereof, may tax, or otherwise take into account—

"(A) in the case of a dividend received from a corporation described in subsection (d), the amount of the deduction allowed by section 243 or the amount not taken into account in determining the tax liability of an affiliated group of corporations in accordance with section 1502, or

"(B) in the case of a dividend to which subparagraph (A) does not apply, more than the lesser of—

"(i) the amount of the dividend (exclusive of any amount determined under section 78), or

"(ii) the amount by which the dividend plus any amount determined under section

78 exceeds the excluded portion of the dividend determined in accordance with paragraph (2).

"(2) EXCLUDED PORTION OF A DIVIDEND.—The excluded portion of any dividend shall be determined by multiplying the amount of the dividend (including any amount determined under section 78) by a fraction—

"(A) the numerator of the fraction shall be the sum of—

"(i) the total amount of tax withheld from all such dividends at the source, and

"(ii) the total amount of tax which by application of section 902 or section 960 to all such dividends, the domestic corporation is deemed to have paid;

"(b) The denominator of the fraction shall be 46 percent of all such dividends.

For the purposes of this section, only a tax for which a credit against tax would be allowed under section 901 (determined without regard to the limitation in section 904) shall be taken into account.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable periods (for purposes of State or local law) beginning after December 31, 1978.

(c) AMENDMENT OF THE TABLE OF SECTIONS.—The table of sections for chapter 77 of such Code is amended by adding at the end thereof the following new item:

"Sec. 7518. Income of corporations attributable to foreign corporations."

* * *

Senator BYRD. The hour of 9 o'clock having arrived, the committee will come to order.

The hearings today will focus on two measures, S. 983 and S. 1688. S. 983 is sponsored by Senator Mathias, and S. 1688 is sponsored by Senators Mathias, Huddleston, Javits, Morgan, Nelson, Talmadge, and Wallop.

S. 983 is a general bill dealing with national standards governing State taxation of interstate commerce and State taxation of worldwide corporate income.

S. 1688 is a more limited proposal dealing with State taxation of worldwide income.

Each of these measures should be considered carefully. Businesses need to be assured that several States will not tax twice the same business income. At the same time, States need to be assured that businesses which operate in more than one State pay each State their fair share of taxes.

The committee looks forward to the testimony of each of these witnesses on these measures.

The committee will first hear from the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy. Welcome, Mr. Secretary. We are glad to see you again.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Thank you, Mr. Chairman. It is good to be here.

If you please, I would like to submit our prepared statement for the record, and talk very briefly about the two principal issues that are raised by the legislation before you.

Senator BYRD. That is satisfactory.

Mr. LUBICK. We are here to present the views of the Treasury Department on the various bills limiting the extent to which States or localities can take account of foreign source income in imposing their income taxes.

There are two principal problems that are addressed here. The first deals with State unitary apportionment taxation systems as applied to foreign corporations, and the second deals with the State taxation of dividends received by a domestic corporation from a foreign corporation as well as rents, royalties, and other foreign source income.

Treasury has a significant concern with the first problem because of its impact on our international tax relations. The second problem raises questions of the relationship of the States to the burdens on interstate and foreign commerce and is of professional concern to the Treasury only insofar as the rules may give a preference to foreign over domestic investment. As far as the relationship between the State governments and the Federal Government, that, of course, is not our area of expertise.

Let me talk first a little bit about unitary apportionment systems which apply to determine the income subject to taxation in a State from a multijurisdiction operation. Under the unitary system, the total income is apportioned by a formula, and traditionally three factors have been used, payroll, tangible property, and sales.

The formula takes the payroll in the State as compared to the total payroll to get a percentage, the same with sales and the same with property, in the State and outside the State. These percentages are applied to the total income, to determine the portion attributable to the State.

Now, traditionally, this apportionment formula has been used for a single corporation doing business in several States, and it has worked reasonably well. If all jurisdictions followed the same rule, obviously, there would be no double taxation. They would arrive at the same result.

The Supreme Court has said in a number of opinions that in the absence of congressional regulation, there can be differences among the formulas, and in one case, the Supreme Court upheld the use of a single factor for apportionment. So you can have differences, and within the United States, within the domestic area of taxation, the factors tend to be more or less similar so that the amount of double taxation that may be involved is certainly within tolerable bounds.

Now, the question that we are concerned with here goes beyond the apportionment of income of a single corporation. We are concerned with the problem where the States require combined reporting of income of affiliated corporations of a unitary business. In other words, the State may require the inclusion in the income base not only of the income of the corporation incorporated within that State, but of foreign corporations around the world, on the theory that it is all part of one business.

Now, what makes a business unitary, of course, is a difficult concept to define, but suffice it to say that some States have held that merely the function of centralized management in one corporation is a sufficient tie to bring in all of these other corporations.

Now, the problem addressed by the bill, then, is the inclusion of income of foreign affiliates who are not directly involved in business in the State in the combined report subject to apportionment. A number of examples have been shown through the application of the apportionment formula to show that this produces some rather serious distortions, and allocates into the State income from foreign corporations that one would find it hard to attribute to that particular State.

I will give a couple of illustrations, and I am sure you will hear some more.

A second difficulty besides the malfunctioning of the apportionment formula in the international scene is that in the case of foreign owned multinational corporations, the States require them to translate into U.S. dollars and U.S. accounting concepts all of the transactions and activity of these foreign corporations that may otherwise have nothing to do with the particular State involved. That is a very serious burden on the foreign corporations.

Our third problem is that the conventional international practice for determining what income is attributable to a particular jurisdiction is the arm's-length method, the reference to arm's-length standards of pricing or other payment to determine the true income attributable to a particular jurisdiction.

Now, the result has been some very serious burdens on foreign corporations. We have received many representations from foreign governments. As you know, this whole matter was the subject of debate on the United Kingdom-United States treaty a few years back, where we had previously negotiated a limitation on apportionment in that situation.

The Senate did not accept it in ratifying the treaty, and indeed, there was much suggestion that the matter ought to be handled through the legislative route, through both Houses of Congress.

And it appears to us that this is a very substantial problem as far as our relations with foreign governments are concerned, and that it would be appropriate for Congress to deal with this problem.

A number of illustrations of very serious distortion have been inserted in the record on various hearings, and in particular the hearings involving the United Kingdom treaty, and I won't trouble you to repeat them. But let me give you just one example that was brought out in that hearing, and that is the French company which was engaged in the food business in California which, as you know, is a very low margin business.

As a result of the unitary concept being applied, there was brought into the combined report a lot of its income from the pharmaceutical business, a very high margin business. You can see that if there are differences in wage factors, or with the United States paying higher wages than is true in many other foreign countries, you are going to have a distorting effect on the formula. You are going to generate the attraction of more income to the States, and that operates rather unfairly.

So, it is our position that we would very strongly support the proposal to limit the States in applying the unitary method of taxation by an arbitrary formula in the case of foreign owned corporations.

It is particularly true not only because of the inequity, but also because of the great difficulties for foreign corporations in translating foreign currency and accounting concepts into U.S. terms and also because of the aspect of our international relations.

The same principle, as far as inequity, can apply to U.S.-owned multinationals that are competing with foreign nationals, but we do not have the latter two aspects, namely, the problem of translating into U.S. standards, because they have to do that anyway, or the problem of our international relations.

Nevertheless, we think you ought to take into account the fact that the U.S.-based corporations do compete on a worldwide basis with their foreign-based multinationals, and it would not seem inappropriate to have the same rules applicable in those situations.

Now, as to the second problem, if I can State it briefly, we are dealing with the question of how far States can go to tax income not from business operations in the States, and the prime example that we are concerned with are dividends received from a foreign corporation by a domestic corporation.

The legislation would significantly restrict the extent to which the States can include that in their income base.

Now, our prime concern, as I stated initially, is tax neutrality as between foreign and domestic investment, and we have listed on pages 6 and 7 of our prepared statement a number of very, very difficult questions that are involved. The questions of allocation here are of horrendous complexity, and we think that not enough thought and consideration has been given to this.

For example, we have the question of whether we should restrict State taxation at all. Is this the role of the Federal Government? Can we have different rules which say that a State cannot tax income that is derived from foreign sources, let's say from the United Kingdom, whereas a State is allowed to tax income that is derived from a sister State.

Why should there be a difference between the two? Why should there be one rule for individuals which is different from the rules for corporations? Why should there be a different rule as to dividends as opposed to royalties, interest, and the like?

There are simply a host of questions here, Mr. Chairman, and the question is of such horrendous complexity that we would urge that action on this particular aspect of the problem be delayed, and that very serious study by the staff be given as to all of these problems and all of the possibilities—the questions are mind boggling—that you move ahead rather expeditiously on the simple problem, the one that is relatively clear, and deal with the unitary taxation situation.

I would be glad to answer any questions that you may have.

Senator **Byrd**. I take it, then, that Treasury favors part of the bill and opposes another part. Is that it?

Mr. **Lubick**. That is correct, Mr. Chairman. We are in favor of a limitation on unitary apportionment as applied to foreign-based multinationals. We suggest that the same rule is probably appropriate with respect to restriction on apportionment of income to U.S.-based multinationals. We don't have the same professional interest in it in the Treasury, but we do think the principles are appropriate.

As to the balance of the bill that deals with the question of dividends and other foreign source income of domestic corporations, we think that there are so many serious problems here that we are not prepared to come up at this time with any reasonable solution. We would get into more difficulties through some of the simplistic approaches that have been proposed than are appropriate at this time.

So, we would urge you to defer any action and to study this question rather thoroughly.

Senator **Byrd**. Thank you. Just a moment.

[Pause.]

Senator Byrd. Mr. Lubick, you submitted to the House a written statement regarding H.R. 5076, which is identical to S. 1688. Would you submit for the record a copy of that?

Mr. Lubick. We would be delighted to do that, Mr. Chairman.

Senator Byrd. Thank you.

[The prepared statement of Mr. Lubick and statement on H.R. 5076 follow:]

FOR RELEASE UPON DELIVERY
9:00 a.m. (E.D.T.)
June 24, 1980

STATEMENT OF THE HONORABLE DONALD C. LUBICK ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY BEFORE THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON S. 983 AND S. 1688

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the Treasury Department's views concerning the issues raised by S. 983 and S. 1688 regarding state taxation of foreign source income. The primary objective of S. 983 transcends the foreign income issue; the bill would establish national standards governing state taxation of interstate commerce. While the issues associated with this broader objective are very important, they are not, strictly speaking, Federal tax policy issues. Accordingly, my comments will be confined to the foreign income issues raised by the two bills. S. 983 and S. 1688 would clarify the extent to which a state, or political subdivision, may take account of certain income from sources outside the United States in imposing its income tax.

Each bill has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to essentially foreign corporations and the other dealing with state taxation of foreign source income. Regarding the foreign source income part, S. 1688 is restricted to dividends received from a foreign corporation whereas S. 983 also applies to interest, rents, royalties, license and technical fees, and gains from a foreign source.

Under the unitary method of apportionment, as applied in several states, the income of a corporation doing business in a state is determined for state income tax purposes by

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applying a formula which usually includes the income, payroll, property, and sales of the corporation subject to tax, as well as all related corporations which are considered part of a unitary business. Thus, the income of a corporation doing business in a state is determined by dividing or apportioning the total domestic and foreign income for the controlled corporate group according to the relation between the corporation's in-state activities and the world-wide activities of the entire corporate group. Unitary apportionment may be contrasted with the typical formula apportionment method used by nearly all the states which divides or apportions the income of a single corporation in relation to its business activities in the jurisdictions in which it operates. A unitary business generally exists where there is (1) common ownership; (2) centralized operation, such as purchasing, advertising, and accounting; and (3) a centralized executive force. No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The unitary apportionment part of S. 983 and S. 1688 is aimed at the practice of including foreign corporations in the unitary apportionment system.

This practice creates three types of problems. First, it may result in a determination of income for state tax purposes which is substantially different than the income which would be attributed to the corporation doing business in the state on an arm's-length or separate accounting basis. To the extent that the relationship between the apportionment factors (usually payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears to generate substantially more tax revenue for the states than does the arm's length or separate accounting method. Second, the practice may impose a substantial administrative burden on a taxpayer, involving annual translation of the books of a large number of foreign corporations into U.S. accounting concepts and U.S. currency. Third, the practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method which is used by the Federal Government and is generally accepted in international practice.

Although the restrictions on the unitary apportionment method in the two bills differ, the intent is the same: to prohibit application of the unitary method to essentially foreign corporations. Section 303(b) of S. 983 provides that in determining a corporation's taxable income on a combined or consolidated basis, no state may require and no corporation may elect that the combined affiliated group include any corporation deriving substantially all of its income from sources outside the United States. A corporation fulfills the "substantially all" test if at least 80 percent of its gross income if derived from sources outside the United States over the preceding three-year period. Although section 303(b) would apply to either domestic or foreign corporations, the 80 percent test demonstrates that it is designed to prohibit application of the unitary method to corporations with basically foreign operations. The unitary portion of S. 1688, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formula the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of "the corporation" (presumably the foreign corporation) is subject to Federal income tax.

Although neither bill distinguishes between corporate groups under United States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of the unitary method of apportionment, only the first--the potential for a distorted measurement of taxable income--applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit annual financial statements to the IRS with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a U.S. controlled group. Similarly, the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

The Treasury Department supports the goals of S. 983 and S. 1688 with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of these bills insofar as U.S. controlled corporate groups are concerned.

There are, however, several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be addressed. We have pointed these problems out in a written submission to the Chairman of the House Committee on Ways and Means regarding H.R. 5076, which is identical to S. 1688. We would, of course, be pleased to work with the staff of this Committee in any further drafting that is undertaken.

Each of these bills would also restrict state taxation of income received by a corporation from a foreign source. S. 983 would apply to foreign source income generally, but S. 1688 is restricted to dividends. Forty-six states, including the District of Columbia, levy taxes with respect to corporate income; these taxes are either denominated as income taxes or as excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign source income, that is, income from sources outside the United States. In most states, the treatment of foreign source income is determined by the general rules applied by the states for taxing the income of a corporation which operates across state or national boundaries.

Taxable dividends, interest, rents, royalties, and other items of income received by a corporation, whether domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in which economic values or activities of the taxpayer within the state are compared with the taxpayer's total activities or values of the same kind everywhere. (The unitary method discussed above is a special case of formula apportionment in that the formula is applied to the entire affiliated corporate group, rather than to a single corporation.) States differ in how they define business income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> ...income arising from transactions and activity in the regular course of the taxpayer's trade or business [including]... income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most items of nonoperating income would be considered nonbusiness income and would be specifically allocated.

Allocation is the attribution of an income item to a specific geographic category; the particular income is thus attributed wholly to a given state, or is wholly excluded from taxation by a given state. Taxable dividends for example, that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the state of the taxpayer's commercial domicile. Rental income from real property is usually allocated to the state of the property's situs.

Section 302 of S. 983 provides that foreign source income received by a corporation may be neither apportioned nor allocated to any state. In addition to dividends, this prohibition would apply to interest, rents, royalties, license and technical fees, and gains from foreign sources. Thus, this bill contains a broad prohibition on the state taxation of foreign source income. In contrast, S. 1688 is addressed only to dividends. S. 1688 would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section 861(a)(2)(A), foreign source and (2) all foreign corporations. The domestic corporations treated as foreign under the bill are corporations which either have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources.

The excluded portion of the dividend received from these domestic corporations is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, S. 1688 would exclude from the states' tax base either 85 percent or 100 percent of dividends received from these corporations.

With respect to dividends received from foreign corporations, the portion excluded by S. 1688 is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes.

This exclusion, however, will frequently be less than the alternative exclusion in S. 1688, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate tax and dividend withholding tax) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or 23 percent, one-half the dividend would be excluded from the state tax base.

The question of how states should treat foreign source income for tax purposes deserves far more attention and consideration than we have given it to date. Both S.983 and S.1688 would restrict state taxation of foreign source income. Is this the correct result? If so, why does S.1688 apply to dividends, but not to interest, rents, royalties, and other categories of foreign income? Both bills apply to corporations; why are individuals and other taxpayers excluded? Because a multistate corporation pays both Federal and state income taxes on its operating income, limiting state taxation to U.S. source income may tilt the tax incentives toward foreign investment and employment. Is that appropriate?

Even if we conclude that states ought in principle to be able to tax foreign source income, should the Federal government nonetheless place some limits on that jurisdiction? What happens when two or more states, because of conflicting rules of corporate taxation, assert the right to tax the same income? If states are taxing on the basis of domicile, and not just U.S. source, should they have an obligation to credit foreign taxes or otherwise eliminate international double taxation? S.1688 provides for a partial (or in some cases a total) exclusion of foreign source dividends from taxable income for state tax purposes. But in many cases that formula goes well beyond eliminating double taxation and the formula's underlying rationale is unclear. Perhaps the states should, like the Federal government, allow a credit for foreign taxes paid or deemed paid by the U.S. recipient. That approach would, however, require coordination of foreign tax credits among the state and Federal governments, which may be complex and create other problems.

In short, the issues raised by limitations on state taxation of foreign source income are far more complex and their appropriate resolution far less certain than the unitary apportionment issue for foreign corporations. Because it is critical that we resolve the unitary apportionment problem expeditiously, we favor going forward now with the unitary portion of the bills before us, but holding the foreign income issues over for further consideration.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

SSISTANT SECRETARY

Dear Mr. Chairman:

This is in response to your request for views of the Treasury Department on H.R. 5076 (96th Congress), entitled "A bill to amend the Internal Revenue Code of 1954 to clarify the extent to which a State, or political subdivision, may tax certain income from sources outside the United States."

The bill has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to foreign corporations, and the other dealing with state taxation of dividends received by a corporation from a foreign corporation.

Under unitary apportionment systems as applied in several states, the income of a corporation doing business in the state is determined for state income tax purposes by applying a formula taking account of the income, payroll, property, and sales of the corporation subject to tax and all related corporations which are considered part of a unitary business (i.e., whose activities are dependent upon or contribute to the business of the corporation whose income is being taxed). No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The first part of the bill is aimed at some states' practice of including foreign corporations in the unitary apportionment system.

The practice creates three types of problems: (1) It can result in a determination of income for state tax purposes which is substantially different (greater or less) than the income which would be attributed to the corporation doing business in the taxing state on an arm's-length or separate accounting basis. To the extent that the relationship between the three apportionment factors (payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. (2) The method can impose a substantial administrative burden, involving translation of the books of what may be a substantial number of foreign corporations into U.S. accounting concepts and U.S. currency. (3) The practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.

The first part of the bill, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formulas the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of "the corporation" (presumably the foreign corporation) is subject to Federal income tax.

Although the bill makes no distinction between corporate groups under United States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of unitary apportionment, only the first--the potentially distorted measurement of taxable income--applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit financial statements to the IRS annually with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a group controlled from the United States. Similarly, the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

In addition to the considerations discussed above, the bill raises some important issues of Federal-state relations in the tax area and more generally. Although the international application of unitary systems causes substantial difficulties, there is some question whether these problems should be addressed by Federal legislation or by treaties. Arguably, it is appropriate for the Federal Government to limit the taxing authority of the states only when there is an overriding purpose for doing so.

On balance, the Treasury Department supports the goals of paragraph (a) of the bill, with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of paragraph (a) of the bill insofar as U.S. controlled corporate groups are concerned.

There are several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be noted. In paragraph (a), lines 9 and 10 refer to amounts "includable in the gross income of such corporation." It is unclear whether "such corporation" refers to the corporation subject to state tax or the foreign corporation whose income can be taken into account only in limited circumstances. From the context it appears to be the latter, but if the intention is to preclude the application of unitary apportionment except to the extent that amounts are included for Federal tax purposes in the income of the corporation subject to state tax, that intention should be made clearer.

In paragraph (c), "affiliated group" is very broadly defined as a group of corporations "connected through stock ownership" with a common parent. This definition should be more sharply drawn to indicate the degree of stock ownership required in order for a corporation to be a member of an affiliated group. Since, in general, states require a control relationship for an affiliated corporation to be a part of a unitary business, a 50 percent ownership test might be appropriate.

Paragraph (d) provides that corporations described in section 861(a)(2)(A) are to be treated as foreign corporations. These are domestic corporations which either have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources. It is understandable why this rule applies with respect to paragraph (e), which deals with state taxation of foreign source dividends. It is not clear why this definition of a foreign corporation should apply for purposes of paragraph (a). Paragraph (a), generally speaking, appears directed at preventing state unitary apportionment systems from taking account of income not subject to Federal taxation. The income of corporations described in paragraph (d) is subject to Federal taxation.

The second part of the bill, paragraph (e) of proposed Code section 7518, would restrict state taxation of foreign-source dividends received by corporations. Forty-six states, including the District of Columbia, levy corporate income taxes; these are either direct taxes on income or indirect excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign (outside the United States) source income. In most cases, the treatment of foreign source dividend income derives from the general rules for taxing dividend income received by a corporation. Under these rules dividends received by corporations from foreign sources are generally excluded from the tax base in about one-third of the states and generally included in the tax base in about two-thirds of the states.

Taxable dividends, whether of domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in which economic values or activities within the state are compared with the taxpayer's total activities or values of the same kind everywhere. States differ in how they define business income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> ...income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most dividends would be considered nonbusiness income and would be specifically allocated. Allocation means the attribution of an income item to a specific geographic source; the particular category of income is thus attributed wholly within or wholly without a given state. Taxable dividends that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the taxpayer's commercial domicile.

The bill would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section

861(a)(2)(A), foreign source and (2) all other foreign corporations.

The excluded portion of the dividend received from domestic corporations described in section 861(a)(2)(A) is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, the bill would exclude from state tax bases either 85 perceht or 100 percent of dividends received from corporations with less than 20 percent U.S. source income.

With respect to dividends received from foreign corporations, the excluded portion is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes. This exclusion, however, will frequently be less than the alternative exclusion in the bill, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate and dividend withholding) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or 23 percent, one-half the dividend would be excluded from the state tax base.

The Treasury Department has no objection to requiring that the section 78 "gross-up" be excluded from the state tax base. This would merely require a state to allow an exclusion or deduction for foreign taxes. Although many states already allow this, it seems reasonable to require all states to recognize foreign taxes as a legitimate business deduction.

The treatment of dividends provided by the remaining provisions of the bill, however, might unintentionally favor foreign over United States investment. Many, but not all, states follow the Federal practice of allowing a general deduction for intercorporate dividends from essentially domestic corporations. Consequently, the exclusion for dividends from foreign corporations provided by this bill might be viewed as placing foreign dividends on an equal tax footing with domestic dividends.

But this overlooks the fact that a multistate corporation pays both Federal and state income taxes on its operating income. The dividend received deduction is intended to prevent the taxation of income that already has borne tax at both the Federal and state levels. Neither Federal nor state income tax is paid, however, on the income of a foreign corporation until it is repatriated as a dividend to the domestic parent. To the extent this bill excludes these dividends from the state tax base, it eliminates the state level of taxation. Accordingly, multinational operations would be taxed more favorably than multistate operations.

The Treasury Department believes that it is undesirable to create such a tax preference for foreign investment. While this is Treasury's primary objection to the second portion of the bill, there are other troublesome aspects. It is unclear why individuals and other taxpayers have been excluded. Similarly, since the bill applies only to dividends, it would favor corporate taxpayers receiving dividends over those receiving rent, interest, and royalty payments. Finally, the bill is geared to the current maximum U.S. corporate rate of 46 percent, rather than the maximum rate in effect at any particular time.

The Office of Management and Budget has advised the Treasury Department that there is no objection from the standpoint of the Administration's ·cogram to the presentation of this report.

Sincerely,

Donald C. Lubick
Assistant Secretary
(Tax Policy)

Senator Byrd. The Chair now recognizes the senior Senator from Maryland, Mr. Mathias. Senator Mathias is the chief sponsor of the legislation being considered today. It was Senator Mathias who, working with the committee, arranged for the hearing today, and we are very glad to have you, Senator Mathias. You may proceed in any way that you would prefer.

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator Mathias. Thank you very much, Mr. Chairman.

With the greatest respect for the Senator from Montana, I might say there is a certain historical interest in the fact that a Senator from Maryland and a Senator from Virginia are discussing this subject this morning.

My mind goes back to the decade of the eighties, in this case, not the 1980's, but the 1780's, when——

Senator Byrd. Way back.

Senator Mathias. Well, an important period in American history, the 1780's. During the 1780's, commerce was being burdened by State taxation. Both interstate and international commerce was being burdened by State taxation, to the extent that it was clear that the struggling American republic under the Articles of Confederation would not survive.

And so a gentleman from Virginia invited a few representative Americans to his home on the banks of the Potomac to discuss the problem, and there, at Mount Vernon, under the leadership of George Washington, these men, discussing the problems of commerce and the struggling American economy, concluded that they ought to call a more representative national meeting, and so they did.

They decided to call a meeting which was soon thereafter held in Annapolis, the capital of Maryland, and there, they pursued further these problems of the burdens on the national economy caused by State taxation, and that in turn led to the call of the Constitutional Convention in 1787.

So, what we are really doing, Mr. Chairman, is dealing here this morning with one of the most fundamental questions that has been before this Republic. It is a question so serious that it gave rise to the call to the Constitutional Convention itself, and it was recognized by George Washington and by the founders of the Republic as being one of the bedrock questions on which the survival of a national economy depended.

So, it is no small problem that we wrestle with here today. I am therefore extremely grateful to the chairman for having arranged this meeting, and to the members of the committee for making it possible. I promised the chairman I would speak very briefly. I really have already talked longer than I had planned to.

Senator Byrd. Go right ahead. It is very interesting.

Senator Mathias. I did want to mention just a few of the features of S. 983 and S. 1688.

Now, the first thing that should be clear is that neither of these bills in any way limit the right of the States to impose whatever level of taxation they please on business that is conducted within their proper jurisdiction. The bills in no way conflict with the notion of States rights.

Instead, they would simply make sure that the individual States apply taxes only to the money earned within that State's boundaries. In that way, business will avoid the threat of double taxation, which can be so extremely damaging, and we would eliminate the considerable confusion by bringing the State practice into conformity with the arm's-length method which is already employed by the Federal Government.

Now, S. 1688 deals with the unitary method of taxation by worldwide combination, by clarifying and limiting the individual State's ability to tax foreign source income of a corporation group which has one member, one unit located within that State's boundaries.

This would prohibit the practice of some States of taxing the foreign source income of a multinational company regardless of whether or not it has been repatriated contrary to the current policy of the Federal Government.

In the case of intercorporate dividend payments, a number of States currently disregard taxes already paid on those earnings before the time of transfer, and in my bill, I would oblige them to observe the same tax credit that the Federal Government allows for any foreign taxes paid on these dividends.

The disincentives to U.S. investment that these State tax methods pose, apply both to American based and to foreign based multinational companies. Domestic corporations suffer, and I think very serious international trade problems have arisen in the case of foreign-owned corporations with the U.S. subsidiaries in the States employing worldwide combination.

Now, S. 983, the Interstate Taxation Act, addresses itself primarily to the domestic interstate commerce situation, and it seeks to establish certain minimum nationwide standards for the imposition of State sales and use and income and gross receipts taxes in order to protect businesses from unfair multiple tax liability in the States where they operate, very similar problems to those that were addressed at Mount Vernon at that meeting in the decade of the 1780's.

In 1964, I was a member of the Willis Committee. That was that special committee set up in the other body as a result of an agreement between the then chairman of the Senate Finance Committee and the then chairman of the House Judiciary Committee to study State taxation of interstate commerce.

At that time, we found that about 2,300 State and local tax jurisdictions were in existence. Today, there are more than 8,000 State and local tax jurisdictions. That means the number of tax rates has quadrupled, the number of tax forms has quadrupled, the number of tax regulations has quadrupled, the number of headaches that taxpayers have has more than quadrupled.

So, today, the inordinate paperwork requirements generated by this multiplicity are alone a reason to seek some simplification, and when you add the confusion of often conflicting rules in different areas, I think it is time to reaffirm legislatively the Constitution's injunction that the State shall erect no unreasonable impediments to interstate commerce. We want to revive that spirit of Mount Vernon.

Obviously, one of the big jobs at these hearings is to allay the fears of the State and local authorities about losing revenues and compromising their freedom to levy taxes. My good friend, Louie Goldstein, the Comptroller of Maryland, is constantly preaching to me on that subject, and so I have it very much in mind myself.

I agree that we have to help the States to see that they have a mutuality of interest with business. The uniform application of the guidelines and rules in my bills would ultimately increase the revenues for State and local governments, since the new incentives for increased investment would far outweigh the possible loss of income.

Business, on its part, would know what the liabilities were, which is a necessary first step toward paying them off.

I have a constituent who has a small business, but the nature of the business is such that he has to do a good deal of interstate business, and he is always getting these forms. Every time he sends out an order to some city or town that happens to have a municipal tax, he gets a form because he has done business there, he has sold one item of his product there.

I said, "Well, Johnny, what do you do with it?" "Well," he said, "I have a bottom drawer in my file, and I just throw it in there, and I hope I will never hear from them again." Well, that bottom drawer is just full of time bombs, and he doesn't know what his ultimate tax liability may be if these communities start collecting.

In addition to the certainty which is so valuable to business, uniform standards are crucial for businesses interested in expanding. They have to know what kinds of new tax liabilities they are going to acquire.

So, Mr. Chairman and members of the committee, I would suggest that we should wait no longer for reform. We can't afford antagonism between business and State governments. We need partnership. What we need and what we must have and what these interstate tax bills will help to bring about is an era of cooperation between government and business that will give a major boost to the American economy which is precisely what those gentlemen of Maryland and Virginia who met at Mount Vernon in the 1780's contemplated, and whose original incentives we can push forward.

Thank you, Mr. Chairman.

Senator BYRD. The Senator from Maryland has made a fine presentation, and I am pleased that the cooperation which existed between representatives of Maryland and Virginia 200 years ago continues in 1980 between the representative from Maryland and the representative from Virginia.

We are very pleased to have you today.

Let me ask you one question, and then I will yield to my colleagues.

You heard Secretary Lubick testify that while the Treasury favors the part of the bill dealing with unitary tax, it opposes the second part, which deals with the taxation of dividends. Do you have a comment on his position?

Senator MATHIAS. Well, I am not sure that I understand the basis of it. It seems to me that in fairness, you have to deal with both sides of that question, and frankly, I am surprised that the Treasury would take that view, because in this day and age, the

pages tightly bound

formation of capital is such a necessary thing in the American economy, as I see it. If we are going to restore productivity in our economy, we have to make it easier and not harder to form capital.

I would think that Treasury would, in the broad interest of the American economy, be taking precisely the opposite view. I must say I am surprised.

My counsel says that as he heard the Secretary's testimony, that he felt that he had not adopted a view in opposition, but that they wanted to think more about that, but that is a frequent position that administrations take, all administrations, not just this one, when they want to oppose without opposing.

Senator **Byrd**. The Chair rather assumed that the Treasury opposed that part of the bill, not the total bill.

Senator **Mathias**. Well, I think, Mr. Chairman, they should have embraced it, and said, this is good for the economy. The way you beat inflation is by improving productivity, and the way you can improve productivity is to make the formation of capital easier, and I think this is one of those steps that would do just that.

Senator **Byrd**. Thank you, Senator Mathias.

Senator Dole?

Senator **Dole**. I have no questions. I appreciate Senator Mathias' eadership in this area.

I note one of his cosponsors is now in the room. As I understand, here are a number of Senators who have indicated an interest in S. 1688 including Senator Wallop, Senator Huddleston, and prob-bly others that I am not aware of, but I am not certain whether ve are going to come to grips with this problem this year, but it is ne that we need to address, and I appreciate very much your tatement.

Senator **Byrd**. Senator Baucus?

Senator **Baucus**. I, too, want to thank the Senator. I might add, hough, that 200 years ago the State of Montana did not impose a urden on interstate commerce.

Senator **Mathias**. The State of Montana could now contribute ward saving the rest of us from the error into which we have ipped.

Senator **Baucus**. I regret that I skipped certain chapters in the ederalist Papers. Over the Christmas break last year, I took the ederalist Papers with me. However, I skipped those sections ving to do with State and Federal taxing power. I am kicking yself this morning for not reading those sections at the time.

The basic premise, I take it, is that present taxing power unfair- burdens certain corporations and discourages foreign invest-nt. On the other hand, the States are sure to argue that they e going to lose revenue.

am wondering if you have undertaken any studies or have any amples which will more precisely illustrate this problem?

Senator **Mathias**. The dramatic example at the moment is the te of California, which has been seeking foreign investment, ing to get more business, and they are being told by various ustrial and business prospects that they want to stay out of ifornia because they are afraid of the unitary tax. They are aid their worldwide operations will all be brought within the net he California tax system.

The Governor of California has done a 180° turn as a result of the kind of reaction, the impact of this upon jobs in California. You know, you can use highflown phrases about the economy, but what it comes down to, it is costing them jobs in California.

I can give you other examples which I will be glad to submit for the record.

Senator **Baucus**. Why can't California, through the California Legislature, address that problem?

Senator **Mathias**. Why does not California——

Senator **Baucus**. Yes.

Senator **Mathias**. Well, the Governor of California has in fact submitted a bill to do just that in California. Lloyd's Bank of California, for example, stated that many businesses have failed to locate in California because of the danger of the application of the unitary tax. Others, including the Hong Kong and Shanghai Bank have considered withdrawing from California because of it.

And the tax manager of BAT Industries of London said:

> BAT believes that the continuance of the present tax system will inhibit new investments in California in an era of slow growth or recession, in a period of depression, with little capital available to new projects. What may be seen now as an acceptable additional operating expense can well become a significant adverse factor in determining the location of new or extended facilities.
>
> In our own case, we have looked at locating a paper processing plant in California and decided against doing so, and in fact, located in the State of Pennsylvania, where the capital cost of the plant is $15 million.

Those are some specific examples.

Senator **Baucus**. You seem to feel that the Federal Government still should address this problem because the States by themselves will not sufficiently correct the problems that you mention.

Senator **Mathias**. Well, the Senator from Kansas said that he questioned whether we would grapple with that this year, and unfortunately, that has been the record here. There have been a number of reasons for not grappling with it this year. One idea was, well, we will let the States form a compact, and in fact, the States did attempt to form a compact to deal with at least some of these problems, but not all the States joined, and of course, without 50 State participation, it isn't worth very much.

Now, I am told that some of the States are backsliding, they are withdrawing from the compact, and as I remarked in my opening and rambling reference to American history, this is one of those problems that seems to yield only to the direct and unified action at the national level, because each State at a given moment in history has some reason for not doing it, and unless everybody does it at the same time, you don't get the benefit from the unified action.

Senator **Baucus**. Thank you, Senator Mathias.

Senator **Byrd**. Senator Wallop is a cosponsor of this legislation. Senator Wallop?

Senator **Wallop**. Mr. Chairman, I have a paper which I would like to put in.

[The opening statement of Senator Wallop follows:]

STATEMENT OF SENATOR MALCOLM WALLOP

Mr. Chairman, as a cosponsor of S. 1688 and as a Member of this Subcommitte, I thank you for scheduling hearings on it. An extensive record has been established on the subjects covered by this legislation on the Senate floor during the debates regarding the United States-United Kingdom Income Tax Treaty, before the Protocol to that Treaty, by the Task Force on Foreign Source Income of the House of Representatives Committee on Ways and Means in 1977, and at a very complete hearing before the House of Representatives Committee on Ways and Means on March 31, 1980. It is valuable to have this opportunity to discuss the legislation here and receive the testimony of those who participate in this hearing.

The Treaty discussions focused considerable attention on the problems caused by the use of the worldwide combined reporting system as used by a few individual states. These states assess taxes of corporations doing business in those states so as to include the worldwide income of affiliated corporations who are not involved in business there and whose activities are not even related. The article that would have limited the application of that system by the individual states was removed from the Treasury in response to the expressed need for a full legislative consideration of the problem by both Houses of Congress, though the Federal Government agreed in the Treaty with Great Britain not to use the system for Federal taxation purposes.

The Supreme Court of the United States in its decision in the case of *Japan Line* v. *County of Los Angeles,* (441 U.S. 434, 1979) expressed the need to avoid multiple taxation and to insure that this Nation spoke with one voice in matters of foreign, rather than interstate commerce. More recently, in *Mobil Oil Corporation* v. *Commissioner of Taxes of Vermont* (U.S. Supreme Court, No. 78-1201, March 19, 1980), the Court acknowleged the lack of uniformity between the states as to taxation of foreign source dividends and said: "Congress in the future may see it fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so." Slip Opinion 22-23.

The legislature of the state which has most consistently used the worldwide combined reporting system, California, has recognized the need to limit the use of that method by its taxing authorities. AB 525, legislation which would restrain the California Franchise Tax Board from using that method so as to combine U.S. corporations with the income of their foreign parents, has passed the Assembly and the Senate Committee of Revenue and Taxation. The Governor of California is on record as supporting limitation of the worldwide combined reporting system.

The International Chamber of Commerce, Chamber of Commerce of the United States, the American Chamber of Commerce in Great Britain, the Business Roundtable, the National Association of Manufacturers, the Committee of State Taxation of the Council of State Chambers of Commerce, the European Economic Community, the government of Great Britain, the Confederation of British Industry, the Dutch Employers' Federation, the German American Chamber of Commerce and most of the major corporations in this country and Great Britain which provide employment for millions of U.S. citizens, have all expressed support for this legislation.

Thus, this Committee has before it S. 1688 in a climate of international concern over the problems caused by the use of the worldwide combined reporting system, judicial recognition of the need for this country to speak with one voice in such matters, and widespread domestic and international support for the legislation from companies and associations which create jobs and investments in this country.

In that latter connection, I noticed with interest an article which appeared in the May 31, 1980 edition of the Washington Post which revealed that the Federal Government has several programs which can provide subsidies to foreign corporations to invest and develop in "depressed areas" of this country.

On the one hand we have such programs to encourage investment in U.S. industy to create jobs and improve business, and on the other we allow a few individual states to construct their own tax systems which in fact discourage foreign industrial investment and employment in the United States. Such examples clearly point out the need for one voice in the area of international taxation.

While I am confident that those who will testify in these hearings will explain the technical details of the bill, it is important to keep in mind that S. 1688 would conform the state rules to the Federal rules within and only within the very narrow area of: (1) the time at which states tax the foreign source income of foreign affiliates, (2) the quantity or portion of foreign source dividends which are taxed.

It is also essential to remember that only a few states actually use the worldwide combined reporting system, and that when the term "foreign source income" is used it is not referring to income of a corporation doing business in a state from its operations overseas, but to income earned overseas by overseas affiliates of that corporation not doing business in that state, or even in the United States.

Thank you.

Senator **Wallop**. Max, a partial answer to your question would be two specifics. One is, the bill deals only in two extremely narrow areas of this unitary concept, and two, that it affects the rest of the country because of the fact that it is possible to exist, it causes and creates hesitation on the part of people who might otherwise be contemplating investing anywhere in America.

We will have to be able to forecast the State's long enough economic life for freedom from this kind of taxation in order to make that commitment, and should it be possible to do this, or to divert this in any State, that in effect affects the foreign investment and capital creation all over the whole country.

This is one reason why I think it is justifiable to enact this legislation. I would hope that we could do something about this bill this year. I have seen that there is a possibility of passage. The fact that the chairman has been kind enough to hold hearings would at least indicate that it is getting serious consideration which I think is well deserved.

I thank the Senator from Maryland for his statement.

Senator MATHIAS. I thank the Senator.

Mr. Chairman, I have a somewhat more comprehensive statement which I have spared the committee, but I would appreciate the opportunity to submit that for the record.

Senator BYRD. Yes, it will be published in full in the record, Senator Mathias.

Senator MATHIAS. Mr. Chairman, I further have some correspondence with the Treasury which the committee might find of interest in the light of Secretary Lubick's testimony this morning, and with the permission of the Chair, I will submit that for the record also.

Senator BYRD. The committee will be glad to have it.

[The material referred to follows:]

SUPPLEMENTARY TESTIMONY OF CHARLES McC. MATHIAS, JR., U.S. SENATOR

Mr. Chairman, my interest in the problems of state taxation of interstate and foreign commerce reaches back to the time I entered the House of Representatives in 1961. I have been pursuing legislation in both houses ever since to resolve some of the major controversies that arise in this complex area. I am grateful that the Senate Finance Subcommittee on Taxation and Debt Management has accommodated my request, to initiate hearings on the interstate taxation issues addressed in my bills S. 983 and S. 1688.

Hearings were held on March 31 in the House Ways and Means Committee on H.R. 5076, the identical House companion bill to S. 1688, which deals with the unitary method of taxation by worldwide combination, currently used in varying degrees by several states of the Union. Under this method, the states can tax companies doing business in interstate and foreign commerce on the basis of their aggregate worldwide income, rather than on that portion of it that is dervived from activities within the taxing state.

I'd like to make clear at the outset that my bills will in no way limit the right of the states to impose whatever level of taxation they want on business within their jurisdictions. They are in no way contrary to the notion of states rights. Instead, my bills would simply make sure that the individual states tax only the money earned within that state's boundaries. In that way, business would avoid the threat of double taxation, and we will eliminate confusion by bringing the state practice into conformity with the arm's length method used by the federal government.

As you know, the federal government treats the subsidiaries and affiliates within a corporate group as separate entities for tax purposes; it imposes a tax only if and when the overseas income is repatriated to the United States. By contrast, some states extend their tax jurisdiction to foreign source income whether or not it has been repatriated. Also, in the case of intercorporate dividend payments, they have disregarded taxes already paid in the home country where the dividend income was generated, while the federal government allows a credit for any foreign taxes paid on these earnings before the time of transfer. They do this even for non-American companies, and these conflicting policies have led to a great deal of confusion and hard feelings among our foreign trading partners.

In the first place, compliance with the reporting requirements of the states using a worldwide combined reporting system entails elaborate record-keeping operations. Many international corporate tax counsels now preside over immense accounting divisions that do nothing but keep track of the tax requirements of state and local authorities oceans away. We should not underestimate the resentment felt by these foreign-based firms at having to assemble and deliver up meticulous operating records to the American state governments that are not required by the legal authorities in their own home territory, and that they would not otherwise bother to keep. My impression is that the objection to this record-keeping imposition by the states in many cases looms larger in the eyes of our overseas trading partners than whatever financial loss is suffered from the tax transaction.

Nearly all the governments of the world market adhere to the arm's length method practiced by the U.S. government for taxing international commerce. The fact that some of the states use the worldwide combination system and apportion dividends, combined with the use of different variations of the method by different state jurisdictions, often leads to double taxation. This hurts domestic corporations with overseas subsidiaries, and has caused serious international trade problems in the case of foreign-based corporations with U.S. subsidiaries in the states employing worldwide combination. Its use by the states invites retaliation against U.S. corporations with operations abroad, and could prompt other countries, who have so far refrained, to adopt it. And, plainly, it discourages new foreign investment in the United States.

The disincentives to U.S. investment that the worldwide unitary tax method poses apply both to U.S.-based and foreign-based multinational companies. To give some idea of the dimensions of the problem, I will quote some remarks from the testimony presented at the hearings of the California General Assembly Committee on Revenue and Taxation last November on Unitary Apportionment and Worldwide Combination.

The Chairman of Lloyd's Bank of California stated: "Many businesses have failed to locate in California because of the danger of the application of the unitary tax. Others, including the Hong Kong and Shanghai Bank, have considered withdrawing from California because of it."

The tax manager of B.A.T. Industries of London said: ". . . B.A.T. believes that the continuance of the present tax system will inhibit new investments in California in an era of slow growth or recession . . . in a period of depression with little capital available for new projects, what may be seen now as an acceptable additional operating expense, can well become a significant adverse factor in determining the location of new or extended facilities. In our own case, we have looked at locating a paper processing plant in California and decided against doing so and in fact located in the State of Pennsylvania, where the capital cost of the plant is $15 million." Pennsylvania refrains from using the worldwide combination approach, and also exempts from state taxation all foreign and domestic dividend payments to corporations within the state that are included in the federally taxable income.

A representative of the California State Business and Transportation Agency testified: "We have found in our department that the most troublesome aspect of California's business tax system is the manner in which the unitary method of corporate taxation is applied to multi-nationals. . . . United Kingdom, Japan, other countries, have decided that as long as California continues to apply the current unitary method they will not locate new facilities in our state. To give you one specific and current example, Rolls-Royce recently examined California as a potential site for a new aircraft engine plant, a plant that would have generated hundreds, perhaps thousands, of jobs but eventually decided not to locate here because of our unitary method of taxation. And we could give you many more examples. This adverse aspect of the unitary method not only discourages new job creation in the state, but is also anti-competitive in that it represents a barrier to entry for new firms. . . . This reaction to the unitary method is most unfortunate, especially considering the number of jobs and extended tax base that would result from business development."

The Sony Corporation of New York declared: "As long as California continues this international double taxation on a worldwide basis, Sony will maximize its effort to invest in other states than California to protect ourselves from this most condemned and unfair tax system."

Finally, a representative of Xerox Corporation described that company's troubled deliberations in 1973 leading to a reluctant decision against establishing a new division in California, despite the other business attractions of that location, due to the overriding stigma of the California unitary tax method: "California was strongly advocated by our highly skilled key scientific and technical people who would be leading our new enterprise; however, our financial staff advised management that a long-range comparison of facts and consequences indicated that in the late 1970s costs to the company of California expansion would be approximately $9.5 million more per year in additional taxes than in a state where the plant was subsequently located. . . . Our financial executives advised that our particular problems with the California theory of unitary taxation required consideration of tax climate in evaluating proposals to further expand plant, personnel and investment within this state pointing out that California extends its jurisdictions even further than the U.S. International Revenue Service. . . . Management then asked the scientific group to demonstrate how a location in California could result in other economies and benefits that would offset the California tax detriment. This burden could not be met and therefore Xerox located its new facilities elsewhere."

I am submitting a wider selection of excerpts from that California hearing as an appendix to my statement.

This concern over stifled investment opportunities was reflected in the recent debate over the U.S.-U.K. tax treaty. The treaty was finally ratified by the Senate last summer, and was passed in the House of Commons in February. As negotiated between the U.S. Treasury and the British government, the treaty included a clause that would have prohibited state governments from using a worldwide combined reporting system in taxing British corporations with American subsidiaries. Under heavy pressure from some states, the Senate deleted this clause—Article 9(4)—from the treaty during the summer of 1978 as a condition for ratification. After the Senate deleted Article 9(4), the treaty went through a prolonged period of uncertainty in Parliament. During this interval, as members of the Finance Committee know, several British delegations visited Capitol Hill to assess the likelihood of progress on S. 1688 and H.R. 5076. The news of the scheduling of hearings on this legislation before the House Ways and Means Committee last spring was received in Parliament before the final vote on the treaty.

I have consulted closely with the Treasury Department throughout my work on S. 1688. The Treasury generally favors the first parts of the bill which would limit the use by the states of the worldwide combined reporting system, and it went on record in support of this measure at the March 31 House hearings where Assistant Secretary Lubick presented testimony. The Treasury has reservations, however, about the last section of the bill, which concerns the treatment of intercorporate dividends. It thinks that my dividend proposal would create a tax preference for foreign investment, while I maintain that S. 1688 would only equalize the situation by obliging the states to recognize the foreign tax credit that the federal government observes. I am submitting my correspondence over this issue with the Treasury Department for the hearing record. Since the hearings in the House, we have been trying to forge an acceptable compromise on the dividend section of the bill, and have made some promising advances in this direction. Our progress is described in Mr. Lubick's testimony for the present hearings in the Finance Committee.

S. 983, the Interstate Taxation Act, has a longer history than the narrower bill I have been discussing. Its lineage can be traced back to my days in the House when, in 1964, I served on the House Special Committee on State Taxation of Interstate Commerce. Since that time I have introduced a series of bills to untangle the burdensome, often conflicting state laws in this area. S. 983 addresses itself primarily to domestic interstate commerce situations, and seeks to establish certain minimum nationwide standards for the imposition of state sales and use taxes, in order to protect businesses from unfair multiple tax liability in the states where they operate.

Although no hearings have been held on S. 983 in the present Congress before today, I held extensive hearings on its predecessor, S. 2173, during the 95th Congress, when the bill was referred to the Judiciary Committee. The hearings were fruitful, and built a solid record for action this year in the Finance Committee. I would like to enumerate some of the improvements that were incorporated into S. 983 as a result of the Judiciary Committee hearings.

In the income tax title, changes are primarily technical. Basically, the bill still provides an optional three-factor formula for apportioning the income of interstate corporations. This three-factor approach, which considers sales, property and payroll, would divide taxes fairly between the various jurisdictions. While a taxpayer could use the formula provided in the state law, the three-factor formula and other provisions of Title III would determine the maximum tax liability that could be imposed. I should add that this three-factor formula is already used in most of the states, so it wouldn't revolutionize state tax collection.

I have revised last year's version to accommodate the two most common criticisms made at the field hearings. One change makes it clear that the taxpayer would not have the option of electing worldwide combination while the state would be prohibited from requiring such combination. The other change clears up some confusion in the treatment of foreign source income in Section 358.

Unlike the income tax title, the sales and use tax title has undergone major revision in the direction of compromise.

The proposed changes will relieve small business of a lot of paperwork. They include an innovative "buyer certification plan" which would greatly reduce the burden on those businesses without a business location within the taxing state. At the same time, the revision assures, to a large extent, the rights of the states to collect sales and use tax revenues. Large businesses, which generally have the resources to comply with existing law, are excluded from the buyer certification election under two provisions. First, they ordinarily have a business location within the taxing state and, second, buyer certification is permitted only for those firms that have less than $100,000 in taxable sales within the taxing state. That jurisdictional trigger is based on the previous year's sales.

The buyer certification procedure allows a purchaser to certify the rate and amount of local and state sales or use tax to the buyer. This certification could be included on the purchase order. Sellers would collect the certified amount and remit that directly to the state without accounting for destinations within the state. If a buyer refused to certify, the seller would collect the maximum combined state and local tax applicable in the state.

The U.S. Secretary of Commerce would be involved in three minor ways: first, the Secretary would prescribe a standard form; second, a return filed with the Secretary would suffice as a return filed with any state; and, third, each state would certify to the Secretary the maximum combined state and local rate within that State.

In addition, persons with taxable sales of less than $20,000 in a state would be exempt from filing returns except to the extent that they had collected a tax from the buyer. Again, qualification for this exemption would be based on the previous year's sales.

Finally, the requirements for exemption certificates on exempt sales have been tightened up. The provision in the draft bill is essentially identical to the one found in S. 2080, which I introduced in the 94th Congress. Also, I have deleted the household goods exemption which was often criticized by State authorities.

On the gross receipts side, I have added the phrase: "Nothing herein shall affect the power of a state or political subdivision to impose a gross receipts tax on intrastate activities, including a tax levied on the extraction of oil, coal or minerals."

This addition should put to rest many of the fears expressed by West Virginia and other gross receipts states.

I think this draft takes a significant step toward uniformity—which business needs—and full accountability—which the states rightfully demand. To the extent there is some tax and administrative relief, such relief is focused narrowly on the small firm trying to extend its sales beyond its home state.

One of our big jobs at these hearings—in the case of both S. 983 and S. 1688—is to allay the fears of the state and local authorities about losing revenues and compromising their freedom to levy taxes. We must help them to see that they have a mutuality of interest with business on this matter. There are legitimate concerns on both sides, and I am pleased that there now appears to be some movement away from the extreme positions of only a few years ago and toward a middle ground. Little by little, we are coming to appreciate that this important issue, with its weighty implications for the nation's international commercial transactions, should be resolved by federal legislation.

It seems to me that everyone has something to gain from this legislation.

The uniform application of the guidelines and rules in my bills would ultimately increase revenues for state and local governments, since the new incentives for increased investment would far outweigh the possible loss of revenue. Businesses, for their part, would know what their liabilities were, which is the necessary first step toward paying them off. In addition, uniform standards are crucial for businesses interested in expanding or diversifying their operations. And it is only through such business growth that the state and local governments will be able to increase their tax bases significantly.

An efficient tax system is to everyone's advantage domestically. Internationally it is a must.

The United States no longer dominates the world marketplace. We have to compete with other economies whose effeciency is nearly legend. The examples that leap to mind, of course, are Germany and Japan.

Our competitors overseas are efficiency-oriented. They put great value on ensuring that commerce flows freely both domestically and internationally. And an efficient economy includes efficient government and the efficient collection of taxes.

A tax system, such as ours, that creates headaches and uncertainties is the enemy of efficiency.

Business already must weigh a multitude of essentially unpredictable and uncontrollable factors—supply, demand, weather, mood, competition. In the face of all this inevitable uncertainty, it is ridiculous that taxation—something we have the power to control completely, something that could be simple, straight-forward, and predictable—is a mare's nest of complexity, fraught with uncertainty, and in a constant state of flux.

By tolerating such an irrational system, we cripple our businesses in the world of foreign trade. And the American consumer pays through the nose for it.

My point is simple—if rational people were to sit down to devise a rational tax system, they would not devise a system anything like ours. Japan and Germany had the advantage of starting out with clean slates after the war.

We can't wait any longer for reform. We must act now. For too long, the debate has been bogged down in the technical language of the experts. We have passively adopted their terms of reference and conducted the debate on the wrong level. We must raise the level of the debate and talk frankly about the larger issues—about jobs, the national interest, and economic survival.

We cannot afford antagonism between business and state governments. What we need, what we must have, and what my legislation will help to bring about, is an era of cooperation between government and business that will give a major boost to the American economy.

My bills are a first step toward a more efficient and more equitable system of taxation. I was encouraged by the progress we made in the 95th Congress, and I am convinced that finally, after so many years, we will be able to bring this project closer to fruition in the 96th Congress.

October 1, 1979.

Hon. G. William Miller,
Secretary of the Treasury,
Washington, D.C.

Dear Mr. Secretary: I am writing to request your comments on two bills I introduced earlier this year, both of which have an oblique bearing on the United States-United Kingdom Income Tax Treaty that is now under review in the British Parliament.

One of the major points of controversy in the course of the Senate's consideration of this treaty was the worldwide combination of corporate income for state tax purposes, addressed in Article 9(4). As you know, this article would have prohibited the use of the "unitary" worldwide combined reporting system in determining the state tax liability of British corporations, but was removed from the treaty by reservation. The prohibition on the unitary method had the support of your predecessor, Mr. Blumenthal, who was convinced that the new incentives for increased investment would outweigh the possible loss of revenue by the states, and would prove a comparatively minor concession.

In this connection, I have been approached from many quarters and urged to move forward on my Interstate Taxation Act of 1979, S. 983, which has a provision similar in intent to the deleted Article 9(4). Specifically, Section (303) of the bill would forbid states from requiring that a combination or consolidation of an affiliated group include, for purposes of determining taxable income, any corporation, 80 percent or more of whose income is derived from sources outside of the United States. The bill would thus accomplish for our tax interactions with all nations what our negotiators attempted to achieve in Article 9(4) for the United Kingdom alone. In the face of the mounting interest in this legislative initiative, I recently introduced S. 1688, a scaled down version of S. 983, which concentrates entirely on the foreign commerce aspects of the earlier bill.

I understand from many of my friends in the United Kingdom that Parliament will ratify the U.S.-U.K. Treaty only if they perceive that we are serious about making progress on the Interstate Taxation bill, or some version of it. While I have taken every opportunity to discourage such rigid "linkage" developments, since they generally precipitate consequences opposite to the ones sought, I am unable to predict the course of action the British government, itself under considerable pressure from British industry, will pursue. In view of this lingering uncertainty, I am most eager to have your assessment of these two proposals. I am enclosing copies of the bills and the accompanying floor statements for your examination. Thank you for any attention you can lend to this matter.

With best wishes,

Sincerely,

CHARLES McC. MATHIAS, Jr.,
U.S. Senator.

DEPARTMENT OF THE TREASURY,
Washington, D.C., November 2, 1979.

Hon. CHARLES McC. MATHIAS, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR MATHIAS: This is in reply to your letter of October 1, 1979, to Secretary Miller enclosing copies of S. 983 and S. 1688 and asking for the Secretary's views on these bills.

We have studied both bills. Most of the provisions of S. 983, other than those also dealt with in S. 1688, are not within the areas of competence of the Treasury Department to comment on. We are focusing our attention, therefore, on the two aspects of S. 1688—limits on the application of unitary apportionment and state taxation of foreign source dividends.

We have some difficulty, as a matter of tax policy, with the dividend proposals in S. 1688. The limitations on the right of states to tax dividends from foreign corporations would tend to favor foreign over domestic investment by U.S. investors. A multistate corporation pays both state and Federal income tax. State income taxes are, of course, deductible for Federal tax purposes. To the extent the bill curtails state taxation of foreign source dividends, multinational operations would be taxed more favorably than multistate operations. The Treasury Department believes that it is undesirable to create a tax preference for foreign investment.

We are well aware of the problems caused by the application of state unitary apportionment systems to foreign based corporate groups. As you know, we strongly supported the effort to limit such application in the proposed income tax Convention with the United Kingdom. We are somewhat less certain of the extent to which these problems are also present in the application of unitary apportionment to U.S. based corporate groups. We are continuing to study this matter, and we hope to be able to provide you with a fuller report on our views in due course.

Sincerely,

GENE E. GODLEY.

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C., November 29, 1979.

Hon. GENE E. GODLEY,
Assistant Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. GODLEY: Thank you for your response to my inquiry concerning S. 983 and S. 1688. I look forward to the full report on the Treasury's views that you mention in your letter.

Frankly, I am much heartened to learn that the Treasury Department plans to study in depth the complex issues that are raised in my bills. I expect that the Finance Committee will schedule hearings on the bills early in the next session of Congress, and we would all weigh heavily the expert views of the Treasury Department.

In the interest of focusing the debate, I would like to take this opportunity to comment briefly on several of the points you raise. For one thing, a number of states do not apply their corporate income tax to dividends, and most of the states that do tax such dividends allow the 85–100 percent dividend deduction provided in Section 243 of the Internal Revenue Code for the federal tax. In addition, some states, including the major industrial states, do not tax foreign source dividends. Most of the states that do tax such dividends do so by picking them up in the federal tax base, but they do not recognize the foreign tax credit. Therefore, the present state tax system tends to discriminate against foreign investment in a manner contrary to tax policy as established by the Congress for federal taxes. Rather than create a tax preference for foreign investment, as you state in your letter, S 1688 would only equalize the situation.

In general, it is my experience that corporations with American parents have the same kinds of problems with the worldwide combination system of unitary apportionment as do foreign corporations doing business in this country, whether through a U.S. subsidiary or not. The same kind of distortions result from great differences between countries in, among other things, wages and profitability. Also, American companies with foreign operations face the threat of multiple taxation, which the Supreme Court ruled was repugnant to the Commerce Clause in the *Japan Line* case.

I am advised that the support of American business for restrictions on worldwide combination is generally contingent upon a satisfactory solution of the foreign dividend problem. This is the case because if the dividend problem is not solved satisfactorily, the use of worldwide combination becomes the lesser of two evils, since this procedure at least eliminates intercorporate dividends.

I am also advised that a federal legislative approach to these problems that applies only to companies with foreign parents will be vigorously opposed by American business. I think we should bear this in mind as we attempt to address the problems legislatively.

Clearly these problems require Congressional action if we are to live up to our responsibility to carry out the mandate of the Commerce Clause. I look forward to working closely with the Treasury Department in carrying out this responsibility. I know of your continuing discussions with foreign governments concerning the "foreign policy" that a few states continue to pursue, contrary to federal tax policy and contrary to international standards of taxation, and I applaud your efforts to harmonize these conflicting policies. Together I think we can fashion a remedy that will fully respect the legitimate concerns of the states.

Thank you again for your interest.

With best wishes,

Sincerely,

Charles McC. Mathias, Jr.,
U.S. Senate.

Excerpts From the Hearings on Unitary Apportionment and Worldwide Combination, Held by the California Assembly Committee on Revenue and Taxation, Los Angeles, Calif., November 13, 1979 [1]

1. ASSEMBLYMAN MORI

Disincentives in the business world to me are very subjective in nature and maybe this is why we haven't had any in-depth examination and scientific examination as to which really is a disincentive. One fact that I'm aware of in two trips to Japan in the past and Taiwan in the past year, every single business person that I talked to without exception, large, medium and small, when we discussed the prospects of investment in California, the matter of the unitary tax was raised. Now whether its subjective or empirical or whatever, I'm not talking about one or two or three, I'm talking of dozens of corporate people that I have spoken with, one element that always arises in unitary tax.

* * * And would submit to you, Mr. Miller, that the unitary tax is a significant disincentive, particularly if in fact the disincentive is on the margin as it may be in California. With the other things to be considered, even if it were 20th or 30th on the list of importance, that marginal decision when a business is on the margin of making that decision, something 50th on the list may be the key element that causes that business to locate or not to locate. It doesn't have to be the first element. It could be many elements and something way down on the list that is a marginal element. (pp. 24, 26)

2. MR. STAFFORD GRADY, CHAIRMAN, LLOYDS BANK OF CALIFORNIA

Many businesses have failed to locate in California because of the danger of the application of the unitary tax. Others, including the Hong Kong and Shanghai Bank, have considered withdrawing from California because of it. This was established beyond doubt by two days of hearings before the Franchise Tax Board on August 22 and 23, 1977. This in turn prevents or lessens opportunities for employment of California residents and will prevent the state from achieving its rightful place as a foremost world center for international trade, commerce and banking. (pp. 39-40)

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[1] Page numbers are from the hearing transcript.

3. MR. D. J. HAYWARD, TAX MANAGER, B.A.T. INDUSTRIES, LONDON

Finally, B.A.T. believes that the continuance of the present tax system will inhibit new investments in California in an era of slow growth or recession. This state can be justly proud of its past economic achievement, but, in a period of depression with little capital available for new projects, what may be seen now as an acceptable additional operating expense, can well become a significant adverse factor in determining the location of new or extended facilities. In our own case, we have looked at locating a paper processing plant in California and decided against doing so and in fact located in the State of Pennsylvania, where the capital cost of the plant is $15 million. (pp. 53–54)

4. MR. ANTHONY MONEY, FINANCIAL CONTROLLER, FOSECO, INC.

In screening potential investments many factors are considered, but there is no doubt that the unitary tax is a very negative indicator. Foseco worldwide has a fairly high profit for employees, but only 2 out of every 1000 of its employees work in California. The California results have little effect on the worldwide profit and consequently the amount of franchise tax paid is governed primarily by the size of the California payroll. This form of payroll tax places us at a disadvantage in California compared with competitors who are less successful than ourselves worldwide. In consequence, prospective ventures in California have to offer well above average returns to overcome the tax disadvantage. Investments are often unprofitable in the early years and only later do they hopefully contribute to corporate earning.

The franchise tax being levied irrespective of profits earned in California, adds to the financial commitment and risk involved in a new venture. Again, this factor discourages new investment or the creation of jobs in California.

Member corporations of the group are inhibited from operating, especially those with outside stockholders. Thus unitary tax has a strongly negative effect on investments and the creation of new job opportunities in California. (pp. 56–57)

5. MR. RICHARD KING, BUSINESS AND TRANSPORTATION AGENCY, STATE OF CALIFORNIA

With one exception California is generally competitive with almost every other state when compared on the basis of these factors, but the exception, and a very flagrant exception, is in the area of state taxation.

Less than two years ago California's tax burden was exceeded only by Alaska and Hawaii.

* * * We have found in our department that the most troublesome aspect of California's business tax system is the manner in which the unitary method of corporate taxation is applied to multi-nationals. This taxing method uses a ratio of the firm's worldwide and California's sales, payroll and plant value in determining taxable income in California. It has been our experience that this unitary method represents a serious constraint in California's ability to attract new industry since it can result in the firms having to pay state corporate income tax even if the new plant actually had a net loss. Since it is quite common for a new plant to experience net loss in the first few years of operation, the unitary method discourages firms from locating new facilities in California.

* * * United Kingdom, Japan, other countries, have decided that as long as California continues to apply the current unitary method they will not locate new facilities in our state. To give you one specific and current example, Rolls-Royce recently examined California as a potential site for a new aircraft engine plant, a plant that would have generated hundreds, perhaps thousands, of jobs but eventually decided not to locate here because of our unitary method of taxation. And we could give you many more examples. This adverse aspect of the unitary method, not only discourages new job creation in the state but is also anti-competitive in that it represents a barrier to entry for new firms. Barriers to entry, economists tell us, tend to produce higher prices and fewer jobs. This reaction to the unitary method is most unfortunate, especially considering the number of jobs and extended tax base that would result from business development. (pp. 58, 59, 60)

6. MR. CHRIS WADA, SONY CORPORATION OF NEW YORK

Currently, we are expanding our Dothan plant now in Alabama. We have started manufacturing magnetic tape in Dothan, Alabama in 1977, and now we have over 900 employees with a $50 million investment. We have just announced that we would add a new business in Japan called the Sony Wilson, where we import Wilson products in the market in Japan. We are now Sony Prudential; we will sell life insurance policies in Japan.

All of these efforts are to minimize our exposure in California, and Sony will and has to maximize this effort to invest in other states than California to protect our service from the most condemned and unfair tax system. (p. 92)

7. MR. HENRY OTA, LEGAL ADVISOR, JAPANESE BUSINESS ASSOCIATION OF SOUTHERN CALIFORNIA

The logical lesson this situation teaches any foreign corporation is not to invest in California because that investment will mean a greater cost than normal, a cost that would be reflected by the application of the unitary tax.

* * * We believe that the testimony by Mr. Wada of Sony will help clarify any feelings amongst any of the members of the Committee that once a company comes to this State that the unitary tax will no longer become an issue with them. We certainly see and we feel that decisions to go to other states are significantly influenced by the existence of the unitary tax.

As a result of these feelings, we, as an Association, feel that this State cannot be complacent because it may lose its opportunity to continue with tremendous financial growth. Japanese business entities have reacted to the strong urgings of the Federal Government to invest in manufacturing facilities as a means of correcting the trade imbalance. This encouragement was emphasized by the Task Force Report on the United States-Japan trade, which was issued on January 2, 1979 by the Subcommittee on Trade of the House Committee on Ways and Means.

In regards to investment in this State, and we know that there are reports about continuing investment by representatives from Japan, we should probably focus on the type of investment that has been coming. We are not seing the major manufacturing operations coming to this State. We know the news reports show that states like Tennessee are attracting away from California the large television manufacturers. Of course, there are many business factors that have to be taken into account, but there is little question that the unitary tax issue is raised and considered in their decision making process. (pp. 96, 97, 98)

8. MR. THOMAS WENGLEIN, XEROX CORPORATION

Tax policies of the State of California discourage Xerox from expanding in the state. Specifically in 1973, this corporation made a decision not to establish its Office Systems Division in California due in a major part to what was viewed as an unfair burden as compared to other states. The facility was subsequently located in another part of the country. Major reasons for the unfair California tax burden are: One, the worldwide unitary concept with the inclusion of foreign income in a tax base, and, two, the combination of separate and distinct business operations. California has a lot going for it. The decision not to locate in California was a very difficult one.

California was strongly advocated by our highly skilled key scientific and technical people who would be leading our new enterprise; however, our financial staff advised management that a long-range comparison of facts and consequences indicated that in the late 1970s costs to the company of California expansion would be approximately $9.5 million more per year in additional taxes than in a state where the plant was subsequently located.

California taxes would have been $6 million more than in New York. This estimate was based upon our long-range projections and cumulative increases in property, payroll and sales. Our financial executives advised that our particular problems with the California theory of unitary taxation required consideration of tax climate in evaluating proposals to further expand plant, personnel and investment within this state pointing out that California extended its jurisdictions even further than the U.S. Internal Revenue Service.

That is the increased property, payroll and sales in this state results in a higher apportionment factor being applied to an income base that includes foreign income. It was also the company's view that this problem was worsened in our particular circumstances because of significant minority interests in our foreign operations and distortions comparing California property and payroll to say United Kingdom payroll or Mexican property investment. Management then asked the scientific group to demonstrate how a location in California could result in other economies and benefits that would offset the California tax detriment. This burden could not be met and therefore Xerox located its new facilities elsewhere. (pp. 102-03)

9. MR. CHRIS WADA, SONY CORPORATION (SUPPLEMENTARY TESTIMONY)

Our capital investments in Alabama and other areas are helping us. Currently we are expanding our Dothan Plant in Alabama, where we now have over 900 employees with $50 million dollar investment in manufacturing magnetic recording tapes in cassettes. We just announced that we would add $25 million and 600 more people to meet both domestic and overseas demand for video cassettes. Since we started this investment in the State other than California, our exposure to California's unitary tax on a world-wide basis has improved. As long as California continues this international double taxation on a world-wide basis, Sony will maximize its effort to invest in other States than California to protect ourselves from this most condemned and unfair tax system.

Anyone who comes for advice from our California experience, will learn we suffer from and fight against this world-wide unitary tax in California. (p. 163)

10. MR. R. L. DELAP, CALIFORNIA COUNCIL FOR INTERNATIONAL TRADE (SUPPLEMENTARY TESTIMONY)

We know that foreign firms which have considered establishing operations in California have in many cases been reluctant to do so, in in some cases already have decided not to do so, in large part because of the unitary tax issue. For the same reason, other foreign firms which did have operations in California have relocated to other states, and others have threatened to do so. Even California-based corporations of long standing have diverted activities outside the State solely because of unitary tax considerations. (p. 181)

11. ALCAN ALUMINUM CORPORATION

Given such a system of taxation, Alcan Aluminum Corporation obviously must consider the fact that any investment it makes in California may substantially increase its California tax liability far beyond the income shown on its own properly kept books and records. That fact is a substantial impediment to any increased investment in California and, indeed, operates as an incentive to locate operations elsewhere. In that connection, Alcan Aluminum Corporation recently closed two major plants in Riverside and Rocklin, California. While California taxes were not the only factor involved in those decisions—in any business decision there are always numerous factors involved, and no one factor is determinative—the California tax savings were one of the factors considered. (p. 192)

Senator BYRD. Thank you very much, Senator Mathias.

Senator MATHIAS. I again thank the chairman for this hearing and for this opportunity, not only for myself but for other interested parties, in bringing this matter to the attention of the committee.

Senator BYRD. It is a very important matter.

At this point, on behalf of Senator Huddleston, I would like to ask unanimous consent to insert in the record a statement by Senator Huddleston dealing with this legislation, and along with it a copy of a Telex received by Senator Huddleston from Michael Grylls, a Member of the House of Commons in London.

Incidentally, Mr. Grylls has been to this country a number of times in connection with this legislation, and is very much interested.

Without objection, these will be inserted for the record.

[The prepared statement of Senator Huddleston and other materials referred to follow:]

STATEMENT OF SENATOR WALTER D. HUDDLESTON

Mr. Chairman, thank you for holding these hearings. I am pleased to be able to add my support as a cosponsor of this legislation and to have my statement included in the record of these hearings.

As that record will reveal, this legislation is important to United States corporations with foreign affiliates and to corporations from other countries which have invested in this country, have affiliates here, and employ U.S. citizens. The United States-United Kingdom Double Taxation Treaty recognizes that and contains the pact of the United States and the Untied Kingdom not to utilise the worldwide combined reporting system method of corporate tax assessment.

However, as you will recall a reservation to the Treaty made that pact applicable only to the Federal Government, and not to the individual States, so that the question could be addressed legislatively. Extensive debate on this question has occurred on the Senate floor in regards to the Treaty, and before the House of Representatives Committee on Ways and Means at its hearing on March 31, 1980, regarding the identical counterpart to S. 1688, H.R. 5076.

I had the opportunity to meet Michael Gryls, Member of the House of Commons last July when he was in Washington to attend the hearing on the Treaty before the Senate Committee on Foreign Relations. During our conversation Mr. Grylls made it plain to me that the British consider an ultimate resolution to the problem posed by the use by certain States of the worldwide combined reporting system method of tax assessment essential to any relationship regarding double taxation between the United Kingdom and the United States.

Recently I received a telex from Mr. Gryls which discusses the feelings of Parliament regarding this problem and the legislation before your Committee. I request that the text of that telex which is attached be included in the record of these hearings with my statement.

Again, I am pleased these hearings are being held. From the information provided the Committee should be able to fully consider the legislation and pass on its merits expeditiously so that this international tax problem can be solved in the national interest.

Thank you.

DEAR SENATOR HUDDLESTON: I understand that this bill which you cosponsor will be the subject of hearings on June 24, 1980, before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally. You will recall from our conversations last year in connection with provisions of the United States-United Kingdom Double Tax Treaty how important is an ultimate resolution to the vexing problem of the use of the worldwide combined reporting system method of corporate tax assessment.

As a Member of the House of Commons since 1970, and as Vice-Chairman of the Conservative Industry Committee I have been vitally interested in the relationship of government and industry, both nationally and internationally. Therefore I followed the debates in Congress regarding the Treaty very closely, specifically the treatment therein of the use of the worldwide combined reporting system in assessing the taxation of companies doing business in both our countries, and even elsewhere. The Treaty's limitation on the use of that method by the States would have prevented double taxation. Barriers to international investment would have been removed, and the number of jobs would have been preserved and even increased in both countries. With the original Treaty, which included that limitation on the States, the United States government seemed to be saying to Great Britain, "We want your business and your jobs, not just your taxes."

From our discussions, and other visits in Washington, I understand the positions of those Members of Congress with whom I and other Members of Parliament have met, that while they were in favor of the limitation, they felt that Federal legislation was the correct way to accomplish it.

Thus, when the House of Commons considered the Treaty on February 18, 1980, we did so with a major portion of the Treaty removed but with confidence that the Congress intended to fully examine the problem caused by a few of the individual States using the worldwide combined reporting system. Many of our most important companies with affiliates operating in the United States were placed at great risk as a result of the Treaty reservation. They were left subject to the vagaries of that extraordinary and unfair taxation system of worldwide combination even though they were not actually doing business there.

The positions of the governments of Britain and the United States regarding this problem is fixed by the Treaty. Your Federal Government has agreed not to utilize the worldwide combined reporting system in assessing the taxes of British companies. Of course, we understand that the Federal Government does not use that method at all, and only utilises the "arms length" method. Yet at present, absent legislation such as S. 1688 and its House of Representatives counterpart, H.R. 5076, the individual States are free to apply any method. While we understand the concept of "states' rights" it does not seem proper that individual States should speak with different voices on matters on international taxation. Fifty-one different tax policies from one country are confusing.

We not only believe the worldwide combined reporting system to be unfair, but judge it to be counter-productive as well. Without limitation severe impediments to enlarged industrial investment and subsequent decreases in numbers of jobs will result. This has been recognized by the Members of the California State Assembly and Senate as legislation there, AB 525, to limit the application of the method by the California Franchise Tax Board has passed the Assembly and been approved by a Senate committee. Without limitation, British and other companies that are subjected to the abuses of the system will, at the end of the day, be forced to withdraw.

I understand that lengthy hearings were held in the House of Representatives Committee on Ways and Means. We are most hopeful that this hearing and that will provide the information necessary so that Congress may resolve this issue. As I stated in the House of Commons debate on February 18, 1980: "It is crucial for business relations between two countries as close as Britain and the United States that this matter should be resolved. Otherwise we risk generating friction not only between our business enterprises but between our countries."

I wish you and your fellow Members of Congress success in your deliberations.

Sincerely yours,

MICHAEL GRYLLS.

Senator BYRD. Next will be a panel consisting of Mr. Ernest S. Christian, Jr., Committee on State Taxation, State Chambers of Commerce; Mr. John S. Nolan, British National Committee, International Chamber of Commerce; Mrs. Connie Borken-Hagen, American Chamber of Commerce, United Kingdom; Dr. Lothar Griessbach, German-American Chamber of Commerce, accompanied by Mr. Jack E. Gabriel; Mr. G. Kenneth Christrup, director of taxes, Xerox Corp., on behalf of the Rochester Tax Council; Mr. Neil Munro, Taxation Department, Confederation of British Industries; and Mr. Michael J. Kennedy, senior vice president, Tax Executives Institute, accompanied by Mr. William L. Lynch, managing director of the Tax Executives Institute.

Welcome, ladies and gentlemen. You may decide in which order you would like to go. Mr. Nolan?

STATEMENT OF JOHN S. NOLAN, BRITISH NATIONAL COMMITTEE, INTERNATIONAL CHAMBER OF COMMERCE

Mr. NOLAN. Thank you, Senator Byrd.

Mr. Chairman and members of this honorable subcommittee, I appear for the British National Committee of the International Chamber of Commerce in strong support of S. 1688, and commend Senator Mathias and Senator Wallop for their courage in sponsoring this extremely important measure.

S. 1688 is vitally necessary to protect the foreign commerce of the United States from unreasonable taxation by a few States in the United States. The worldwide unitary apportionment method of taxation used by these few States such as California, as applied to foreign-owned corporate enterprise, such as United Kingdom companies doing business in the United States, creates major barriers to United Kingdom investment in the United States and to international trade between our two countries. Income earned entirely outside the United States by such foreign-owned companies, often by companies within a United Kingdom corporate group which do no business in the United States, is, in effect, arbitrarily allocated by these few States to their own tax base. Unreasonable and sometimes even impossible administrative burdens are imposed on these United Kingdom corporate groups.

Total U.S. direct investment in the United Kingdom at the end of 1978 was $20.3 billion, the largest U.S. direct investment in any other country except Canada. United Kingdom direct investment in the United States was $7.4 billion, representing 18 percent of all foreign investment in the United States, greater even than Canadian direct investment in the United States. The actions of California and a few other States threaten the vitality of these international trade and investment flows between our two countries, and the circumstances call for Federal legislation to place some reasonable limits on the ability of the States to tax the foreign commerce of the United States such as S. 1688 would do.

S. 1688 would simply limit the right of the States to tax such income to the extent the Federal Government itself does so, an entirely rational limit. When the recently executed United States-United Kingdom Income Tax Treaty was originally negotiated by the two Governments, it contained an article 9-4 which would have prevented either Government or their political subdivisions from taxing income of a parent company or a subsidiary of the other country or any third country if that parent or subsidiary was not doing business in the first country. That article, to the extent that it would apply to the States of the United States, was removed as a result of Senator Church's reservation, but many congressional leaders have publicly indicated that the matter of such worldwide unitary taxation of United Kingdom companies by a few States, such as California, should be considered by the Congress in a legislative context.

The British have reason to expect such consideration. S. 1688 is a fair and reasoned response to these developments. The case against the use by the States of the worldwide unitary apportionment method is clearly strongest with respect to foreign-owned corporate groups such as United Kingdom companies. The arbitrary allocation of worldwide income earned largely outside the United States by United Kingdom corporate groups doing business throughout the world, by reference to plant, payroll, and sales, tends to grossly overstate the income which States like California allocate to themselves. Wage rates and plant costs in California tend to be much higher than in other parts of the world. California has stringent pollution control requirements, causing a relatively higher property investment per unit of production in that State without an equivalent increase in profit. Even the sales factor causes major distortions, overallocating income to California.

The worldwide unitary allocation system overallocates income to a State like California also because profits do not bear a uniform relationship to the allocation factors. Profit margins in developing countries are likely to be much higher in relation to costs, to reflect greatly increased risks of expropriation, currency fluctuations, and other such reasons.

Arbitrary allocation of worldwide profits by reference to plant, payroll, and sales will allocate part of these high-risk profits to California even though they have nothing to do with operations in that State. California allocates worldwide income even though such income includes substantial profits in foreign countries which are blocked and which for this reason alone would not be subject to U.S. income tax even if the profits were otherwise taxable by the United States.

California has applied unitary worldwide apportionment to allocate income of a United Kingdom corporate group to California even when it is clearly demonstrable that actual operations in California have resulted in a loss.

This system is contrary to all accepted international principles of income taxation. The major industrialized countries, including the United States, through their international organizations, have approved the principle that a company should be taxed in a country only if it has a permanent establishment there and does business in that country. Such actions by the States also violate the treaties of friendship and commerce which we have entered into in the United States with 25 foreign nations. This fairly invites retaliation by foreign governments against U.S. companies, with serious potential burdens on U.S. business overseas.

During the 1960's, when Congress thoroughly studied this subject through the Willis subcommittee, it was clearly concluded that reasonable limitations on the power of the States to tax, such as those contained in S. 1688, were vitally necessary.

Accordingly, I strongly urge the subcommittee and the Senate Finance Committee to report S. 1688 to the Senate. Thank you.

[Mr. Nolan's official foreign registration is in our committee files.]

Senator BYRD. Thank you.

STATEMENT OF ERNEST S. CHRISTIAN, JR., COMMITTEE ON STATE TAXATION, STATE CHAMBERS OF COMMERCE

Mr. CHRISTIAN. Thank you, Mr. Chairman.

My name is Ernest Christian. I am with the law firm of Patton, Boggs & Blow. I am counsel to the Committee on State Taxation of the Council of State Chambers of Commerce, or COST, as it is known.

COST supports the more extensive provisions of S. 983, and we commend Senator Mathias for it, but our oral statement this morning will be confined to the two provisions of S. 1688 which relate to State taxation of foreign source income.

The Committee on State Taxation is speaking from the standpoint of American companies. That is, U.S. parent corporations with foreign subsidiaries which operate abroad. From the standpoint of American business, elimination of the worldwide combination method of State taxation is vital.

That method as applied by California and a few other States is contrary to State, Federal, and international principles. Worldwide combination is simply an attempt by a State to extend its tax jurisdiction worldwide, an attempt to tax foreign subsidiaries which are not doing business in the State or even in the United States, and an attempt to tax income which the State absolutely has no right to tax.

Why should a State impose a penalty tax on a U.S. corporation merely because that corporation has one or more foreign affiliates which have nothing to do with that State?

Why, as Mr. Nolan has mentioned, should a State require a U.S. corporation to pay large amounts of tax to that State when the corporation has a loss from the business it conducts in that State? Yet these incongruities can and do result under the worldwide combination method.

Rather than being Federal interference in State taxation. S. 1688 merely prevents a few States from interfering with the foreign commerce of the United States, to the detriment of all citizens of all States.

From the standpoint of American companies with foreign subsidiaries, the second part of S. 1688 which limits State taxation of foreign source dividends is of equally vital importance. From the standpoint of many American companies, elimination of worldwide combination without also imposing a limit on dividend taxation might be almost a fruitless gesture.

Under basic principles of State taxation, a State is entitled to tax that portion and only that portion of a corporation's income which the State's economy has generated. In the case of foreign source business profits of a foreign corporation and dividends paid from those profits, no State properly should tax that income, since no State's economy has generated that income.

Most States adhere to this principle, but a growing number tax foreign source dividends despite the fact that States should not tax foreign source dividends at all, and despite the fact that States typically do not tax intercorporate domestic dividends.

S. 1688 would merely reduce somewhat the present discriminatory tax against dividends from foreign corporations. Properly, States should not tax such dividends, but S. 1688 does not go that far. Instead, it imposes merely a reasonable limitation parallel to the Federal system.

If, as some States assert, they should be permitted to tax those dividends, at least the State's rights to tax foreign source dividends should not be greater than the Federal Government's jurisdiction.

Thus, 1688 would permit States to tax foreign source dividends to the extent that the Federal Government effectively taxes those dividends after taking into account the foreign tax credit.

Under S. 1688, the foreign tax credit would be translated into an exclusion, and just as either 85 percent or 100 percent of domestic source dividends are excluded from State tax, anywhere from zero percent to 100 percent of foreign source dividends would be excluded from State tax, depending on the ratio of foreign tax to the U.S. corporate tax rate of 46 percent.

For these reasons, Mr. Chairman, the Committee on State Taxation strongly supports both parts of S. 1688.

I thank you.

Senator Byrd. Thank you, Mr. Christian.

The next witness?

STATEMENT OF CONNIE BORKEN-HAGEN, AMERICAN CHAMBER OF COMMERCE, UNITED KINGDOM

Ms. Borken-Hagen. Thank you, Mr. Chairman.

My name is Connie Borken-Hagen. I am an American lawyer licensed in New Mexico and the District of Columbia, practicing private international law in London, and retained by the American Chamber of Commerce, United Kingdom, an independent, nonprofit organization with over 1,000 British and over 800 American members, and whose primary objective is to encourage trade and investment between and within the United States and the United Kingdom.

Its members are greatly concerned about the dampening effect the unitary tax has had on British-American commerce. The arguments against the unitary tax are many, but because the chamber brings a unique point of view, representing both American and British companies trading internationally, I shall call your attention first to its negative international impact and the climate of distrust that it has created, which has dampened the United Kingdom's enthusiasm for new investment or expansion in America.

At this time of U.S. concern over capital formation, economic growth, and rising productivity, the United States should be encouraging foreign investment to enhance capital formation, create jobs, and improve the U.S. balance of payments, not discouraging it as this tax does. Although States can handle the issue individually, as California is doing at the present time, it does not solve the problem for the other States or for U.S. policy as a whole.

I must strongly emphasize the climate of distrust that is created by this tax in Britain. There is a strong tendency among British companies to wait and see what Congress does. They do not differentiate among our States as clearly as we do here.

The second important point, Mr. Chairman, is that the unitary tax creates a precedent which is ultimately most harmful to American international interests. If established, American companies may experience extraterritorial taxation by foreign countries or their many subdivisions, or American companies may be forced to provide confidential financial information to foreign nations which may be contrary to U.S. laws or certainly contrary to sound business practice.

One duty of government is to provide protection for its companies abroad from unreasonable foreign commercial burdens. One method of protecting a nation's commercial interests is the treaty process, which is slow, tedious, but trusted worldwide.

If the United States permits its political subdivisions to exceed international taxing terms, then other nations can equally permit extensive taxation of American companies' profits and devastating inquiries into those companies' commercial operations.

Third, there is the potential of retaliation by foreign nations, and there is a precedent for such retaliation, which can only hurt our U.S. foreign trade.

Fourth, the tax is a major international commercial irritant. It has caused considerable bitterness between the United States and the United Kingdom, America's closest ally on the commercial and diplomatic levels.

On March 25, when the British and American Governments finally exchanged instruments on the United States-United Kingdom tax treaty, Her Majesty's Government communicated its strong disapproval of the unitary tax to the U.S. Government. The note presented to the U.S. Government says that:

> While the British Government recognizes the considerable achievement of the two governments in reaching a fair and balanced agreement, it would not wish the United States Government to interpret ratification as approval of the unitary tax system.

It concludes that the Government of Great Britain opposes the unitary tax and will continue to negotiate yearly updates of the treaty to have its views understood by the United States.

It is U.S. Government prerogative to regulate commerce among the States and the foreign nations. Because the United States is a world leader supporting free trade in the international marketplace, Congress should immediately establish Federal standards by enacting S. 1688 in its entirety, which would make State tax policies consistent with U.S. tax and international trade policies.

Thank you, Mr. Chairman.

Senator Byrd. Before calling on the next witness, I might say that two witnesses this morning have called the States political subdivisions of the Federal Government. I question the accuracy of that. My recollection is that the States created the Federal Government and ceded certain powers to the Federal Government, and reserved to themselves what powers they did not cede to the Federal Government.

So, I question the assertion that the States are a political subdivision of the Federal Government.

Be that as it may, the next witness may proceed.

Senator Wallop. Mr. Chairman, as a Federalist in the terms of the Federalist Papers, I agree with you. It is not the same relationship, for example, that a county government has to a State government.

Ms. Borken-Hagen. May I say that I was speaking from the viewpoint of the British companies and the British Government, how they view our system.

Senator Baucus. You would think they would understand, given the way our country was born. [General laughter.]

Senator Byrd. Thank you.

Senator Baucus. Maybe they consider us a subdivision of Great Britain.

Senator Byrd. The next witness?

STATEMENT OF LOTHAR GRIESSBACH, GERMAN-AMERICAN CHAMBER OF COMMERCE, ACCOMPANIED BY JACK E. GABRIEL

Mr. Griessbach. Mr. Chairman, Senators, my name is Lothar Griessbach. The gentleman to my right is Mr. Jack E. Gabriel.

I represent the German-American Chamber of Commerce, which is a binational organization representing German business interests in the United States and also American interests in Germany.

I am also authorized to speak for the German Federation of Industries and the German Federation of Trade & Industry the umbrella organization for the chambers in Germany. Membership in this organization is mandatory for virtually every business operating in the Federal Republic of Germany, and this statement represents their views.

The arguments are pretty much a matter of public record. But I would like to submit this written statement for the record, and try to orally highlight some of the points that have come up in the hearings we have conducted in Germany and over here.

It has not been said so far I believe, that the financial implications may even be of minor importance for our companies. It is not at all certain that the companies, after switching to another State taxation system, will be taxed at lesser rates and will carry a lesser financial burden than under the present system. Of course, some companies will profit; others may not.

The main consideration, and I am addressing myself exclusively to the international implications, not to the taxation of dividends, the major consideration is that the unitary apportionment methods as they are applied at the present time are highly arbitrary. They are almost unpredictable. They present such mechanical difficulties that most of the companies, when trying to comply are not able to come up with solutions which would completely conform to those State rules based on unitary apportionment methods.

The problems are further complicated, of course, by the fluctuation of international currency exchange rates which we have experienced over the years. Consequently the main argument of German companies in favor of the bill is that it would create a uniformly applicable system of taxation consistent with international standards such as the concept of taxing income related to the permanent establishment.

We understand that even the California Franchise Tax Board frequently resorts to negotiated settlements or accepts financial statement income because it cannot cope with the immense mechanical difficulties of this system.

We favor Federal legislation on this matter. As you may know, the convention on the avoidance of double taxation between the Federal Republic and the United States is up for renegotiation. Rather than burden the negotiations with this problem, we would very much like to see a solution on the Federal level or through the State legislatures, because the dilemma of dealing with the Federal Government which in some instances has claimed not to have the necessary authority, will be difficult to overcome.

One of the more serious arguments reaches beyond the realm of the U.S. taxation system. We have information that countries in the developing world are very carefully observing what is going on over here. This taxation system might prove to be contagious, and in the future also hurt American business.

Foreign investment is severely hampered by the system. Of course, some companies do have reason to go to California and other States applying the system because of overriding interests. But it is a disincentive, and its abolishment, would attract new investment to this country.

In conclusion, I would respectfully remind the committee that the concept of the bill as far as its international implications are concerned, is supported by the Commission of the European Communities, so you may say that you are dealing here with a uniform European position.

Of course, I am not authorized to speak for them. I am just quoting the essential concensus expressed in a submission by the Commission of the European Communities.

Thank you.

Senator Byrd. Thank you, sir.

The next witness?

STATEMENT OF J. W. GLASMANN, ROCHESTER TAX COUNSEL

Mr. Glasmann. Mr. Chairman, my name is J. W. Glasmann. I m appearing in place of Mr. Christrup for the Rochester Tax Council. I serve as counsel to that organization.

The Rochester Tax Council is a voluntary organization of companies having strong ties with the Rochester, N.Y., area. Council members include companies such as Corning Glass, Eastman Kodak, and Xerox.

If I may, I would like to submit Mr. Christrup's prepared statement for the record.

Senator Byrd. It will be received.

Mr. Glasmann. The council shares the views of the many witnesses the committee will hear today in support of that portion of S. 1688 which would essentially transfer the worldwide combined reporting system of a State such as California into a domestic unitary system by prohibiting any State from including foreign source income of a controlled group of corporations in its tax base until such foreign income is included in the taxable income of the group for Federal income tax purposes.

The council believes that the formula apportionment of income of a controlled group of corporations to a State on the basis of the traditional three-factor formula—property, payroll, and sales—works reasonably well when applied to the domestic income and property, payroll, and sales factors, at least where the operations and management of the group are functionally integrated.

However, the extension of this concept on a worldwide basis gives rise to serious distortions in the apportionment formula because of the wide differences in economic factors such as wages and prices and the uncertain impact of currency exchange rate fluctuations, exchange controls, and the like.

The net result is that the use of the worldwide combined or unitary apportionment system often results in an arbitrary and disproportionately high amount of foreign source income being allocated to and taxed by those few States which require this method of reporting.

Perhaps equally important, as pointed out by Senator Mathias, the worldwide application of the unitary system on a nonuniform State-by-State basis is and will add enormously to the administrative burdens of taxpayer compliance with overlapping systems of taxation of the same income.

Since the arm's length separate accounting standard is the method generally used by the Federal Government and by the international community of nations in taxing foreign income, the council believes that it is reasonable to insist that the States use the same method where their legitimate interests in revenue collections are adequately protected by the vigorous enforcement of the arm's-length standard by the U.S. Internal Revenue Service.

I must say, Mr. Chairman, in recent years the IRS has become more and more vigorous in that area.

I would now like to turn to the second part of S. 1688, which deals with the taxation of foreign source dividends. If combined worldwide reporting is bad for the reasons which others will tell you about—Senator Mathias certainly talked in great detail about it—much worse is the alternate State practice of including foreign source dividends in the State taxing base with no allowance whatsoever for the foreign taxes paid with respect to such dividends and without making any adjustment in the denominator of the apportionment formula for the property, payroll, and sales of the foreign subsidiary which generated the income being distributed as dividends.

This practice can give rise to double taxation with a vengence. In a not untypical case where 100 percent of the after tax income of a foreign subsidiary is distributed as a dividend, it can result in a State taxing the entire dividend, grossed up by the foreign tax, 100 percent of the pretax earnings, with no allowance for the property, payroll, or sales of the foreign corporation.

Under the U.S. Internal Revenue Code, this results because of the interplay of the gross income provisions and section 78 of the code which deals with the tax gross up.

This result has to be wrong. It has to be wrong, because if the taxpayer in the type of situation I am talking about used a combined income reporting, there would generally be little, if any, U.S. tax by the States, so that you have a situation where the dividend income will be taxed at many times the amount that would be incurred if the combined method itself were being used.

Mr. Chairman, I will conclude by saying that the Rochester Tax Council believes that it is essential that the State taxation of foreign source dividends be resolved in any legislation that addresses the worldwide combined reporting problem. Legislation restricting State practices simply to the combined income level will not be sufficient.

Thank you.

Senator **Byrd**. Thank you. You are from Rochester, are you?

Mr. **Glasmann**. I am a Washington lawyer with the firm of Ivins, Phillips & Barker. We serve as tax counsel to the Rochester Tax Council.

Senator **Byrd**. Thank you.

The next witness?

STATEMENT OF NEIL MUNRO, TAXATION DEPARTMENT, CONFEDERATION OF BRITISH INDUSTRY

Mr. **Munro**. Mr. Chairman, members of the committee, my name is Neil Munro.

I am the head of the taxation department in the Confederation of British Industry. The CBI directly represents some 14,000 firms in the United Kingdom and 100,000 more through affiliated organizations. Our membership is drawn from all sectors of United Kingdom industry and commerce.

The CBI firmly supports bill S. 1688. Our members have for a long time been very concerned about the use of unitary taxation with combined worldwide reporting for these main reasons.

First, it is fundamentally unfair and contrary to internationally accepted taxation principles. It is not employed by any national government in the developed world, and it has been rejected by the OECD, of which the United States is a leading member.

Instead, the CBI favors taxation on the arm's-length basis by which a company is taxed in its place of residence as an independent enterprise dealing at arm's length with its parent company and other affiliates.

With your permission, Mr. Chairman, I should like to submit written testimony to the committee which sets out our views in more detail.

Senator **Byrd**. It will be received.

Mr. **Munro**. Thank you.

I shall not take up the committee's time by repeating what is said in that submission, but I should like to emphasize one point. Any tax system which stipulates that a company's tax should be based on the apportionment of the worldwide income of a multinational group according to arbitrary and unrealistic formulas, and without any regard to whether that company actually earned a profit or a loss, cannot in our view be justified.

Second, unitary tax with combined worldwide reporting imposes an intolerable administrative burden on companies in complying with the demands for information from the State tax authorities.

There are two stages to this process. In the first place, companies have to provide detailed information in order to determine whether or not the business is unitary. From the experience of our members, much of this information is of only marginal relevance to the inquiry.

Next, having been adjudged unitary, the company has to file a combined report. For a United Kingdom-owned group, this may mean rewriting the accounts of every member of the group all over the world so as to comply with the accounting requirements of the State in question. Foreign currency amounts have to be converted to dollars.

This information would not be required in this form for any other purpose. Sometimes the information is simply not available. Sometimes it cannot be released without infringing national legislation, for example, the Official Secrets Act in the United Kingdom. Even when it is available, it is a colossal administrative undertaking to assemble it.

Apologists for this form of taxation have attempted to argue that these compliance problems, the existence of which they do not and cannot deny, are no worse than those occurring in a section 482 investigation. This is an extraordinary assertion which we categorically reject. Even if it were true, which it is not, it ignores the obvious fact that section 482 investigations only take place when irregularities are suspected, whereas combined reports have to be filed every year.

Mr. Chairman, my written submission examines these and other points in more detail, but I hope I have said enough to demonstrate the reasons for the grave concern which CBI members feel about this question. There is no doubt that our members regard the existence of this form of tax as a serious disincentive to new investment in those States of America which use it.

In addition to my written statement, I should like to ask for the U.K. Government note on this question, which was sent on March 25, 1980 to the U.S. administration, to be written into the record.

Senator **Byrd**. Yes, it will be received for the record.

Mr. **Munro**. Thank you, Mr. Chairman.

Senator **Byrd**. At this point, I will put in the communication I received today from Mr. John Anson, Economics Minister of the British Embassy, bringing out the viewpoint of his Government in regard to this legislation.

[The material referred to follows:]

British Embassy,
Washington, D.C., June 23, 1980.

Hon. Harry F. Byrd, Jr.,
Russell Senate Office Building,
U.S. Senate, Washington, D.C.

My Dear Senator Byrd: In the context of the hearing of your Taxation Subcommittee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. Anson, *Minister, Economics.*

[Press release issued by the British Embassy Information Department]

U.K./U.S. Double Taxation Convention

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US, which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on 26 August, 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The consequences are unpredictable and arbitrary. The widely varying commercial economic climates in different countries produce inequitable results. Under system it can lead to a demand for tax by reference to group profits earned fr unconnected activities in other parts of the world where they are already tax even although the local subsidiary is incurring substantial losses. On the unit basis there is likely to be unrelieved and unrelievable double taxation. In addit the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, incompatibility with the internationally accepted "arm's-length" basis would gen ate conflicts between the international investing and trading nations and disrupt of international business if the precedent implicit in the Convention were to followed by other countries. Unless common rules for determining the allocation profits between different taxing jurisdictions are followed internationally it will impossible to preserve the essential objective of providing a consistent and cohere international tax framework for business and investment, for which the Unit States and the United Kingdom have striven together with their fellow members the Organization for Economic Co-operation and Development. It is the view of H Majesty's Government that the unitary basis, which is not a practical internation alternative to the "arm's-length" basis, could undo the important and patient int national work that has been achieved in regulating international tax practices, a that every effort is required to discourage the use of the extension of that basis. It to this end that the British and United States Governments have expressly prohib ed its use for the purpose of the respective national tax systems under Article 9(and the issue will be an important aspect of the proposed annual review of t Convention.

Her Majesty's Government has recognised, in ratifying this Convention with t approval of the United Kingdom Parliament, and in its acceptance of the Unit States Senate reservation against Article 9(4) of the Convention, the difficult issu raised within the United States in seeking to limit State taxing powers through t double taxation conventions of the United States. It has also recognized the impo tance of the Convention in its many other aspects for the two Governments and f the business and investment communities on each side. It must be emphasis however that the acceptance of the Senate reservation in no way implies approv of the unitary basis and it is the urgent request of Her Majesty's Government f the reasons given above that the Government of the United States should use i best endeavours to eliminate the international application of the unitary basis taxation.

Mr. MUNRO. Thank you, Mr. Chairman.

Mr. Chairman, that concludes my testimony. I would like t repeat my gratitude for the opportunity to attend this hearing an to testify.

Senator BYRD. We are glad to have you, Mr. Munro. I might say that British industry and the House of Commons have excellent representatives in Sir Graham Page and Mr. Michael Grylls, both of whom have been to see me several times in regard to this legislation. The Senator from Virginia is much impressed with those two individuals.

The next witness?

STATEMENT OF MATTHEW J. KENNEDY, SENIOR VICE PRESIDENT, TAX EXECUTIVES INSTITUTE, ACCOMPANIED BY WILLIAM L. LYNCH, MANAGING DIRECTOR

Mr. KENNEDY. Mr. Chairman, I am Matt Kennedy. I appear here in my capacity as senior vice president of Tax Executives Institute. I am delighted to have the opportunity to testify on a bill that will alleviate a serious and unfair inequity in State tax treatment of corporations.

As I have said, I represent Tax Executives Institute, otherwise known as TEI, which is an organization whose membership consists of approximately 3,500 corporate tax managers and administrators representing about 1,100 small and large United States and Canadian corporations.

TEI supports the adoption of S. 1688 and recommends that consideration of S. 983 in these same hearings should not impede the prompt adoption of S. 1688. TEI supports S. 1688 to stop the practice of certain States, most notably California, from a tax overreach taxing foreign source income under the worldwide combination method after it has already been subjected to taxation by the host country, and also from taxing foreign source dividends a second time.

We are particularly concerned that unless Congress acts now, other States will follow these practices to increase their revenue, however shortsighted such action might be. Indeed, such tax overreaching inevitably distorts business decisions and may ultimately cost the offending State lost revenue rather than gain it increased revenue.

The worldwide combination method is not precise in apportioning income between the taxing State and the foreign jurisdiction. As a result, the same income is often taxed twice, once by the foreign jurisdiction and again by the taxing State. Double taxation results also when foreign source dividends are taxed again by the State, although the earnings from which they have been paid have already been taxed by a foreign jurisdiction.

Double taxation means that a State of the United States is taxing extraterritorially, and thereby interfering with the Federal Government's constitutional obligation to speak with one voice in international affairs. The worldwide combination method and the taxation of foreign source dividends have also spawned considerable litigation, and have increased unnecessarily the costs incurred by corporations in meeting their State tax obligations.

In the light of all these adverse consequences, it is appropriate that Congress act now. Both the Supreme Court and the Senate itself, in deliberating over the United States-United Kingdom tax treaty, called for corrective action to deal with this problem.

S. 1688 represents an appropriate solution. It incorporates the Federal standard for taxing the foreign source income of foreign corporations and certain domestic corporations which either own or are owned by United States corporations. The Federal standard is designed to avoid double taxation. Furthermore, the Federal standard is the one used by the Common Market nations and by the United States in its tax treaties with those nations.

By imposing a uniform standard of taxation on the Federal Government and the States, the Senate will promote tax equity for corporations, will eliminate needless litigation, will avoid antagonizing other foreign nations, and will discourage possible retaliation against the United States, and will also simplify the overall State tax system there by reducing compliance costs.

On the question of taxing foreign source dividends, S. 1688 provides a fair solution by excluding under a formula part or all of the dividend, depending on the extent to which the earnings from which the dividend was paid were taxed by the foreign jurisdiction.

For the reasons I have stated, we recommend that the committee approve S. 1688, and ask that S. 983 not impede the prompt adoption of S. 1688. I respectfully request that my written transcript be included in the final testimony.

Thank you very much.

Senator Byrd. Thank you, Mr. Kennedy.

You mentioned in your testimony that if this legislation is not enacted, you fear that other States, I believe was the way you expressed it, might present a problem to foreign business. Now, which States now present a problem to foreign business?

Mr. Kennedy. Of course, California has been the leader, and since California joined the multistate compact, it has induced a number of those States in the compact to varying degrees to use the California formula. I am not prepared to give you an enumeration of the extent to which each of these States has picked up some pieces of the California scheme, but there are perhaps half a dozen States that use some or all of the California worldwide combination scheme.

Senator Byrd. I take it then that most States, of the 50 States, most of the States do not present a problem in this area. Is that correct?

Mr. Kennedy. That is right.

Senator Byrd. How many States tax foreign source dividends?

Mr. Kennedy. Only a few. I think perhaps the COST representative could give a better answer to that.

Mr. Christian. If I might, Mr. Chairman.

Senator Byrd. Yes.

Mr. Christian. With respect to the first question, the number of States other than California which apply the worldwide combination method, the Committee On State Taxation's research indicates that in varying degrees Alaska, Colorado, Idaho, Montana, North Dakota, and Oregon, in addition to California, apply the worldwide combination method in some circumstances.

As to foreign source dividends, there are about 28 States which in some degree tax foreign source dividends. Some States do not tax foreign source dividends from direct investment, that is, a wholly or substantially owned subsidiary, but do tax dividends from portfolio investment. Others do not tax foreign source dividends at all, and still others tax all foreign source dividends. The number is about 28 States in one degree or the other.

Senator Byrd. Is Virginia among those 28 States?

Mr. Christian. I can tell you in just a moment, Mr. Chairman. I should know that.

[Pause.]

Mr. Christian. I don't want to hold up the hearing. If you want to go on, Mr. Chairman, I will look this up.

Senator Byrd. Yes.

Senator Baucus?

Senator Baucus. Yes, I have one very general question. I understand that the California legislature has passed a bill which essentially says that if a foreign corporation is an overseas operation by 50 percent or more, it is not subject to the combination unitary approach.

I wonder whether the State senate has exempted some businesses from that bill. Does that bill go in the right direction?

Would it sufficiently satisfy your concerns—if it did not have those exemptions—to the degree that you are familiar with that bill?

Mr. **Kennedy**. The bill goes in the right direction, but it will take care of only those foreign earnings that are earned by corporations which are controlled by foreign companies.

Senator **Baucus**. That is not enough?

Mr. **Kennedy**. No, it certainly is not.

Senator **Baucus**. Well, what should States do, apart from some Federal action?

Mr. **Kennedy**. They should follow the rules of S. 1688.

Senator **Baucus**. You don't think that States will sufficiently act on their own initiative when their excessive tax reach discourages operations in the State? Will they back off, like California now is doing?

Mr. **Kennedy**. Well, it is like a football team having each member police himself as to what he should do. You really need a referee to make sure that everybody is going to follow the same rules.

Senator **Baucus**. I have no further questions.

Senator **Byrd**. Thank you, Senator Baucus.

Of course, a foreign corporation, or any corporation has the right o choose which State it desires to operate in, does it not?

Mr. **Nolan**. Well, that is true, Mr. Chairman, except that there re many British companies that have been located in California, or example, for a long number of years. This development wherey California extended its unitary apportionment system to foreign ontrolled corporate groups, United Kingdom corporate groups, egan in the early seventies, as I recall, and it came through a rocess of evolution. Over the years, during the seventies, it has ecome progressively more of a burden on the United Kingdom mpanies that are already located in that State.

Prior to that time, the unitary apportionment system went rough a long process of evolution where originally it was applied allocate income between the States, that is, wholly within the nited States, income between the States, first by single compa- es, and then, as Secretary Lubick indicated, it was extended to ntrolled corporate groups, but again, allocating domestic income. en it was extended to some extent to foreign income of U.S. ups, and then it was extended to foreign controlled corporate ups.

As I have said, it has been a process of evolution, and it has ght United Kingdom companies with substantial investments in ifornia. With their investments already located there, it has ght them and subjected them to unreasonable burdens of tax- on.

enator **Byrd**. When did the unreasonable burden of taxation t start in California?

Ir. **Nolan**. Well, for United Kingdom corporate groups, it came n it became clear that California was going to extend its appor- ment system to worldwide income of foreign-owned corporate ps that were located, that is, owned and controlled outside of United States, and it became clear that California sought to cate, as I say, part of the worldwide income of these United gdom corporate groups to that State.

That started some time in the early seventies.

Senator **Byrd**. Until the early seventies, this was not, then, problem?

Mr. **Nolan**. That is correct.

Senator **Byrd**. There was, from your point of view, no need fo this legislation prior to the early seventies?

Mr. **Nolan**. Well, there were indications, of course, as far bac as the sixties when the Willis subcommittee was working on thi problem that the States were moving in that direction, and th Willis subcommittee, as Senator Mathias indicated, devoted itsel to this problem, but I don't think it really became a serious prob lem in California, where the burden is the greatest, until, as I say the early seventies.

Senator **Byrd**. Is it a significant problem outside of California? realize six other States or five other States are involved, but is i significant outside of California?

Mr. **Nolan**. Well, it is a significant problem in principle, but the amount of investment by foreign corporations in the other States which use this method is not nearly as significant as it is in California. For example, Oregon and Alaska, there is some investment by foreign companies in those States, but it in no way approaches the magnitude of that investment in California, which has sort of become the focal point for this dispute.

Mr. **Glasmann**. Mr. Chairman, also, within the last month or two, we have had two Supreme Court decisions which upheld the constitutionality, if you will, of the worldwide unitary system, and also the taxation of foreign source dividends, with the Supreme Court in effect saying that this is a matter for Congress, it is not a constitutional question.

So, we now have the likelihood that the States will move into this area that have not been there before.

Senator **Byrd**. Yes, I remember in reading that Court decision, this legislation passed through my mind. I think that could have an effect.

Mr. **Glasmann**. Well it is very interesting. In the case involving Mobil Oil and the Tax Commissioner of Vermont, there the State taxed the foreign source dividends without any allowance for the payroll, property, and sales that gave rise to the corporate earnings that were distributed, and the dissenting opinion noted that that increased the tax burden on Mobil in Vermont tenfold. It could be a very serious problem.

Mr. **Nolan**. In several of these cases, the Supreme Court has pointed its finger right at the Congress and said that while this is not a constitutional problem, it is a problem of regulation of foreign commerce of the United States which is the province of the Federal Government under the Constitution. It is, therefore, up to the Congress to decide what limitations should be imposed upon the States' taxation of foreign source income.

Senator **Byrd**. Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF JOHN S. NOLAN BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, JUNE 24, 1980, ON S. 1688

ON BEHALF OF

THE BRITISH NATIONAL COMMITTEE OF THE
INTERNATIONAL CHAMBER OF COMMERCE

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SUMMARY OF PRINCIPAL POINTS

1. The basic objective of S. 1688 is necessary to preserve and strengthen international trade and investment between the United States and its major foreign country trading partners, particularly the United Kingdom. The unitary apportionment system of determining the taxable income of a corporation doing business in a State, which is utilized by a few States, particularly California, Oregon and Alaska, seriously threatens the entire foreign commerce of the United States.

2. The unitary apportionment system is contrary to well established international standards of taxation and imposes unreasonable tax and administrative burdens on foreign owned and controlled groups doing business throughout the world, including business in the United States through a U.S. subsidiary. Thus, action by Congress to impose reasonable limits on the power of the States to tax foreign commerce is vitally necessary.

3. The result of the unitary apportionment system is, in most cases, to grossly over-allocate income to States like California, imposing unreasonable tax burdens on U.K. or other foreign corporate groups. Of equal importance, the California unitary system requires conversion of the worldwide operations of U.K. or other foreign corporate groups to dollars, and in accordance with California accounting and tax

best copy available

standards, including the provision of extensive financial information of U.K. or other foreign companies doing no business in and having no relationship to California or, indeed, no relationship to the United States at all. U.K. and other worldwide foreign corporate groups do not keep their books or accounts in dollars, nor by U.S. accounting standards. The administrative burdens imposed by this requirement on U.K. and other foreign companies are intolerable.

4. Article 9(4) of the new U.S.-U.K. tax treaty provided that the income apportioned by a State could not include the income of the U.K. parent or other U.K. or third country corporation within the U.K. corporate group if the U.K. parent or such other corporation was not doing business in the State. The Senate ratified the treaty with a reservation on Article 9(4). Congressman Ullman supported the reservation on the ground that such limitations on the power of States to tax should be by legislation and not by treaty. In reserving on Article 9(4), the Senate Foreign Relations Committee urged that Congress give full consideration to legislation dealing with this issue. The U.K. Government made it clear that its ratification of the treaty in no way implied approval of the unitary system, and it urgently requested that the U.S. Government endeavor to eliminate the international application of the unitary method of apportionment. The U.K. Government also made it clear that this issue would be an important aspect of their annual review of the effectiveness of the treaty.

5. The failure to implement the basic objective of S. 1688 may subject U.S. companies operating abroad to retaliation by other countries, in imposing greater tax burdens on U.S. companies. That burden would, to a large extent, fall on the United States itself, as increased foreign taxes may result in decreased U.S. taxes by operation of the foreign tax credit.

6. S. 1688 imposes a reasonable limit on the power of States to tax foreign source income arising in the foreign commerce of the United States. The States would simply be limited to taxing such income only to the extent the Federal Government does so.

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STATEMENT OF JOHN S. NOLAN BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, JUNE 24, 1980, ON S. 1688

This statement is submitted on behalf of The British National Committee of the International Chamber of Commerce. The British National Committee represents a broad cross-section of leading industrial and commercial companies in the United Kingdom.

I. Basic Position of British Industry

The British National Committee strongly supports S. 1688, which is before this Subcommittee for consideration, and its companion bill, H.R. 5076, which is before the House Ways and Means Committee. S. 1688 was introduced on August 3, 1979, by Senator Mathias of Maryland (for himself and Senators Huddleston and Wallop), and H.R. 5076 was introduced on August 2, 1979, by Congressman Conable of New York. Congressional action in the direction of S. 1688 and H.R. 5076 is particularly necessary to protect the foreign commerce of the United States from a burden of unreasonable taxation by only a few States of the United States. The effect of the unitary apportionment method of taxation used by these few States on corporate enterprises owned and controlled in the United Kingdom is to tax part of the income of U. K. corporations and their third country subsidiaries even though they do no business in the United States at all. Unreasonable and in some case impossible administrative burdens are imposed on these United Kingdom companies and their third country subsidiaries. In the long run, this can only do serious harm to international trade between the United States and the United Kingdom.

The strongest case for S. 1688, and against the unlimited application by the States of a unitary apportionment system to worldwide income, is with respect to foreign-owned and controlled corporate groups, such as U. K. companies engaged in worldwide business, including business in the U. S. through a U. S. subsidiary. This case was made in the Hearings on the new United States - United Kingdom tax treaty in July, 1977, before the Senate Foreign Relations Committee. It was made on behalf of The British National Committee*, as well as by particular British companies and many others. The fundamental objections to the unitary system were fully developed at that time, and the arguments of California were completely answered. Those materials should be reviewed in considering S. 1688.

The total U.S. direct investment in the United Kingdom at the end of 1978 was $20.3 billion, the largest U. S. direct investment in any country of the world except

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*/ Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the Committee on Foreign Relations, United States Senate, 95th Cong., 1st Sess. 184-206 (1977).

Canada. It represented more than 12% of total foreign direct investment by the U. S. United Kingdom direct investment in the U. S. was $7.4 billion, representing about 18% of total foreign investment in the U. S., outranking even Canada. The unitary apportionment system of taxation used by a few States is fundamentally destructive of foreign investment in the U. S., and because of this result, it is destructive of broader international trade relationships of the United States with other countries. It intrudes directly upon the special responsibility of the Federal Government in the United States to protect the foreign commerce of the United States from unreasonable burdens of taxation.

S. 1688 is a meaningful response to this problem and would operate in a way that would not unduly restrict the States in taxing income of companies doing business within those States. The States simply would be required to limit the extent to which they take foreign source income into account to the extent that the Federal Government itself does so.

II. The Effect of S. 1688

S. 1688 would amend the Internal Revenue Code of 1954 by the addition of new section 7518 (relating to income of corporations attributable to foreign corporations). Section 7518 would provide that a State may not take into account for income tax purposes, or include in income subject to tax, the income of any foreign corporation in any year prior to the year in which such income is included under the Internal Revenue Code. Thus, the foreign source income of a foreign subsidiary of a U. S. parent corporation would be taxed only if and to the extent paid to the United States as a dividend (or deemed paid by application of Subpart F of the Internal Revenue Code, relating to controlled foreign corporations). In the case of a foreign parent corporation of a U. S. subsidiary, the foreign source income of the foreign parent (and any of its foreign affiliates) would never be taxed, because under the Internal Revenue Code that income is not taxed by the Federal Government.

In the case of dividends received by a U. S. parent corporation from a foreign subsidiary, the bills would also permit a State to tax no greater portion of that dividend than the Federal Government effectively taxes. The rationale for this exclusion of a portion of a foreign source dividend is the same as the rationale for the foreign tax credit -- the avoidance of double tax. However, the result is not to require the States to allow a credit for foreign taxes, which would tend to wipe out all State tax on foreign source dividends because the national tax rates in most foreign countries exceed the rates of tax imposed by the States. Instead, the result of the exclusion is to permit the States to tax, at whatever rate they apply to other income, the same portion of a foreign source dividend which the Federal Government effectively taxes after taking into account the foreign tax credit, but no greater amount.

The purpose of this provision of the bill as to dividends, according to Senator Mathias when he introduced S. 1688 (Cong. Rec. daily ed., S11675), is to bring the taxation by States in accord with the Federal Government treatment, as recommended by the Task Force of the House Ways and Means Committee under the Chairmanship of Congressman Rostenkowski.* In effect, the bill provides that in taxing dividends from foreign corporations, the fact that they have paid income taxes overseas will be taken into account. Consistent with Federal tax policy, this will generally prevent double taxation of foreign source income, a result that now must be accomplished, if at all, by Federal legislation in view of the Supreme Court's recent decision in Mobil Oil Corp. v. Commissioner of Taxes, ___ U.S. ___ (No. 78-1201, March 19, 1980). The Supreme Court in that case permitted Vermont to apportion Mobil's dividend income from both foreign corporations and domestic corporations even though all or substantially all of the income was earned abroad, and even where Mobil held only a small minority stock ownership in such corporations. The dissenting opinion observes that the Vermont approach has been used --

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*/ Recommendations of the Task Force on Foreign Source Income, Committee Print of the Committee on Ways and Means, U. S. House of Representatives, 95th Cong., 1st Sess. 30 (March 8, 1977).

> artificially to multiply its (Vermont's) share of Mobil's 1970 taxable income perhaps as much as ten-fold.
> (Slip opinion, Dissent pp. 12-13).

The Supreme Court majority opinion relies in substantial part on the failure of Congress to act in this area --

> Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. * * * Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so.
> (Slip Opinion, pp. 22-23).

The Supreme Court recognized that the apportionment of foreign source dividends could result in taxation of the same income by the foreign countries in which it is earned and by the States, but the Court considered, as indicated above, that this is a problem to be resolved by Congress, not the Court. Enactment of S. 1688 has become particularly vital in light of this decision.

III. Congressional Action Necessary To Protect Foreign Commerce of U. S.

A. Proximate Background of S. 1688: U. S. - U. K. Tax Treaty

The concept proposed by these bills has been in evolution for many years, as hereinafter described. The proximate occasion for this hearing, however, is the adoption of the new income tax convention between the United States and the United Kingdom, finally executed on

March 25, 1980. On June 27, 1978, the Senate gave its advice and consent to ratification of the treaty and two protocols, subject to Senator Church's reservation, which was later incorporated in the Third Protocol of March 15, 1979 (Executive Q, 96th Cong., 1st Sess.). On July 9, 1979, the Senate unanimously gave its advice and consent to ratification of the Third Protocol. On February 18, 1980, the British House of Commons approved the proposed treaty, as revised by the three protocols.

The Third Protocol affects Article 9(4) of the proposed treaty as originally signed on December 31, 1975. Article 9(4) restricts the use of the worldwide/unitary method of apportioning income. The Third Protocol makes Article 9(4) inapplicable to States and local governments, though continuing its application to the Federal Government and to the Government of the United Kingdom. Under the Third Protocol, States and local governments of either country are free to use the unitary method of apportioning worldwide income of related corporations in determining the taxable income of an enterprise doing business within the State or local government, but, strangely enough, the national governments, which currently do not use such a method anyway, are prohibited from using the method. Thus, for example, any and every State or local authority of the United States will be permitted to use a method denied to the Federal Government, thereby presenting the potentiality of utter chaos in the tax relations of the United States with any foreign country.

Article 9(4) of the treaty as originally negotiated by the two Governments would have limited the methods by which the United States, the United Kingdom, and their political subdivisions could tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other country). The proposed treaty would have provided that in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom, and their political subdivisions could not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other country, or of any third country. This provision was intended to apply to those States of the United States (principally California, Oregon, and Alaska) which, in determining the amount of income of a business operating within the State which is to be apportioned to that State for income tax purposes, require combined reporting of all related business operations (including business operations of related foreign corporations whether or not doing business within the State).

The national governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method. Rather, income between related enterprises is determined on a separate accounting basis, requiring the application of arm's-length principles. In the case of the United States, the arm's-length principles are prescribed by section 482 of the Internal Revenue Code.

Essentially, the unitary apportionment system is simply an arbitrary method of assigning a portion of worldwide income of a group of related companies to the State on a formula basis. In the present international context, it is used instead of determining the income actually earned within the State, or instead of determining the total United States income of the corporate group which may then be appropriately apportioned among the States. Under the worldwide apportionment system, total worldwide income of all related companies as a group is allocated or apportioned even though many of the companies do no business whatsoever in the United States. The apportionment is made by a formula, such as one based on the percentage of sales, property, and payroll in the State to total sales, property, and payroll of the entire worldwide corporate group.

The unitary apportionment system is contrary to well-established international standards of taxation, which require that income from companies doing no business in a country be left out of any determination of income to be taxed by that country, including any such determination by an apportionment method. These international tax standards require, however, that all transactions between such companies and any company or companies in the group doing business in the country meet the arm's length standard, so that income cannot be diverted away from the country by intercompany transactions. The separate accounting, arm's-length section 482 type system required of the United States and United Kingdom in the treaty, and used by them in their own tax systems, is used by virtually every other government in the world. The Organization for Economic Cooperation and Development (OECD) and other international trade organizations, after repeated and intensive studies, have consistently concluded that only the separate accounting, arm's-length system is fair and reasonable in taxing international business. They conclude that the unitary apportionment system applied to worldwide income results in unreasonable tax burdens, multiple taxation of the same income, and heavy and unnecessary administrative costs.

S. 1688 addresses the problem of the effort by a few States of the United States to extend their unitary apportionment systems to worldwide income. This effort extends to including non-U. S. income of foreign parent companies and non-U. S. income of third country subsidiaries of such foreign corporate groups doing no business in the U. S., simply because such foreign corporate groups have a U. S. subsidiary doing business in those States. As applied to U. K. corporate groups, this has had particularly unfair and burdensome effects. The history of the U. S.-U. K. treaty developments demonstrates the clear and present need for intensive Congressional consideration of S. 1688.

B. Treaty Developments -- Congressional Commitment

From its inception in 1975, Article 9(4) of the proposed treaty was objected to by the tax officials of a number of states, particularly California. Article 9(4) was largely a reaction to California's efforts in the early 1970's to extend its unitary business concept (on a retroactive basis to all prior open years) to include the foreign parent of a U. S. subsidiary of a foreign-controlled corporate group and all members of such a foreign corporate group throughout the world. Previously, the unitary business concept had been applied only to include U. S. corporations in the group.

In the Hearings before the Senate Foreign Relations Committee on the treaty in July, 1977, Congressman Ullman, Chairman of the House Ways and Means Committee, submitted a letter which included the following:

> It is my belief that if the Federal Government is to place any limitations on the use of combined reporting by State or local taxing authorities, the limitations should be imposed through the regular manner by legislation and not through bilateral tax treaties. The legislative process would give both Houses of Congress the opportunity to hear and consider fully all sides of the issues involved. Moreover, the issues could be considered on their own merits, rather than determined as a quid pro quo for concessions made by a foreign government, which concessions do not benefit the States and localities whose taxing jurisdictions are being limited by this negotiated package. Finally, the legislative process would permit uniform rules to be applied to all taxpayers, U. S. and foreign.
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> On March 8 of this year, a task force of the Ways and Means Committee* issued a report recommending the adoption of legislation in this area. This legislation would, in most instances, preclude the States from taking into account through combined reporting the operations of foreign

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*/ Recommendations of the Task Force on Foreign Source Income, supra.

> affiliates of multinationals, U. S. or foreign. This recommendation, together with any recommendation on the subject which may be made by the Administration, will be considered by the Ways and Means Committee later this year when it receives the Administration's tax reform proposals.
>
> For these reasons, I urge the Senate Foreign Relations Committee to recommend to the Senate that its advice and consent to the ratification of the proposed treaty be reserved with respect to the limitations placed on the taxing powers of States and localities by Article 9(4).

The statement submitted by the Staff of the Joint Committee on Taxation provided:

> Given the problems which exist with the States' methods of apportionment under combined reporting and with the Federal Government's allocation rules, there is considerable disagreement as to which method is preferable in various situations. But the existence of widely differing methods among the States and between the States and the Federal Government in itself creates substantial burdens for taxpayers. In such a situation it may be appropriate for the Federal Government to decide that establishing a single system of income allocation (or at least minimizing the variation of methods permitted) for both the Federal and State governments is appropriate.
>
> However, any Federal action involves balancing the goal of minimizing any interference with the States' traditional authority over their own revenue collection with the desire to alleviate reporting burdens on taxpayers. Also, the action should not produce significant competitive disadvantages between companies doing business within any State or between States seeking to attract new business. Finally, any resolution must deal with a number of technical issues which arise in determining what apportionment techniques may be appropriate in a wide variety of business

> circumstances. In such a situation it can be argued that the appropriate avenue for Federal action is through legislation rather than through bilateral treaties.
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> * * * * *
>
> Thus, the treaty, drafted in the usual manner, does not contain the type of detailed technical rules which can refine a policy to meet the variety of situations faced by corporations and the States in which they operate and can balance the interests of the States with the burdens created on taxpayers. Finally, the provision proposed here, like any treaty provision, has not been subjected to the process of public hearings, comment and debate which can assist in the formulation of precise and balanced rules to deal with a complex problem.
>
> These points tend to argue for a legislative approach to any action which the Federal Government may deem appropriate. The accomplishment of such legislation is a realistic possibility. Earlier this year a Task Force of the Ways and Means Committee recommended to the full Committee that substantial limits be placed on the States' authority to require combined reporting with related foreign corporations. The full Committee will include the Task Force's recommendations in its agenda when it considers tax reform legislation later in this Congress.
>
> The Committee may thus desire to recommend to the Senate that the treaty be ratified with a reservation on this issue.

The Hearings on the Third Protocol were held before the Committee on Foreign Relations on June 6, 1979. Senator Charles Mathias personally appeared at these Hearings along with the Honorable Michael Grylls, a Member of the Parliament of Great Britain. The Senator presented for the record a copy of his proposed Interstate Taxation Act of 1979 (S. 983, 96th Cong.), section 303 of which he stated would accomplish for all nations what the negotiators attempted to achieve in Article 9(4) for the United Kingdom alone. Senator Mathias stated --

> I have heard from a number of people in the United Kingdom that Parliament will ratify the United States-United Kingdom treaty only if there is a perception in Westminster that we are, in fact, serious about making progress on the interstate taxation bill or some version of it. (Hearings, page 16).

The report of June 15, 1979, of the Senate Foreign Relations Committee on the Third Protocol provided (S. Ex. Rep. No. 96-5, 6):

> The Committee urges the tax-writing Committees of the Congress -- the Finance and the Ways and Means Committees -- to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the issue.
>
> The Committee also notes both Senator Mathias' statement before the Committee in support of the Treaty and the Third Protocol and his view that the British "Parliament will ratify the U. S.-U. K. Treaty only if they perceive that we are serious about making progress on the Interstate Taxation bill . . ." The Committee wishes to make clear that it considers expeditious treatment of the Treaty by both the U. S. Senate and the U. K. Parliament to be critical in order to permit the benefits of the Treaty to flow to both sides.

Clearly the Congress has incurred an obligation by these developments to proceed with intensive consideration of S. 1688 and the problem of the application by a few States of the unitary apportionment system to worldwide income of United Kingdom corporate groups.

C. United Kingdom Position: Congressional Action Vital

After the Third Protocol had been approved by the Senate, Mr. Peter Rees, the Minister of State, Treasury, United Kingdom, accompanied by Sir William Pile, Chairman of the Board of Inland Revenue, visited the United States to impress upon American officials the extreme concern of the U.K. Government and of British companies as to the operation of the unitary system of taxation used by certain States (Taxes International, Oct. 1979, page 5). Mr. Rees had discussions with: (1) the Secretary of the Treasury, (2) Senator Russell Long of the Finance Committee, (3) Chairman Ullman, (4) the sponsors of H. R. 5076 and S. 1688, (5) the leaders of some of the principal U. S. corporations, (6) Governor Brown of California, (7) Assemblyman Mori of California, co-sponsor of AB 525 (the Water's Edge Bill of California), (8) other members of the California Legislature and Administration, (9) the chief officers of the California Franchise Tax Board, (10) leaders of both British and U. S. companies operating in California, (11) the Committee on Unitary Taxation, (12) the Multistate Tax Commission, and (13) the Committee on State Taxation.

Upon the occasion of the final execution of the treaty on March 25, 1980, Ambassador Sir Nicholas Henderson, representing the United Kingdom, delivered a note to the United States Government. It succinctly sets forth the objections of the United Kingdom to use by some of the States of unitary apportionment applied to worldwide income. After emphasizing the importance of the treaty to international trade between the U. S. and the U. K., the note states:

> 3. Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.
>
> 4. Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent

enterprise test is the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

5. The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

6. Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organisation for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end

> that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.
>
> 7. Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given in this Note that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

In view of the importance of international flows of direct investment and international trade between the United States and the United Kingdom, Congressional action in the direction of S. 1688 is vital.

IV. Prior Congressional Action As to Unitary Apportionment

Over the past thirty-five years, California and a growing contingent of States employing the unitary business concept to determine their income tax have generally viewed an affiliated group of corporations connected by more than 50% stock ownership as being the same for purposes of applying the unitary concept as a single corporate taxpayer with no affiliates. The State courts have been moderately concerned with the jurisdictional problems involved in including within the measure of the tax the income of corporations which are not doing business or qualified to do business within the State. They overcome their concern by rationalizing that the return required to be filed by the State is a "combined report", not a consolidated return. Intercompany transactions are eliminated, however, as in a consolidated return, so the rationalization is really defective.

The combined report is said to be merely a means of ascertaining the portion of the unitary income arising from sources within the State, which, it is said, does not disregard the separate corporate entities. Thus, the total gross income of the combined group is purportedly not included in the measure of the tax, and the combined return is said to be the return only of the corporation doing business within the State and not of the other corporations whose income is included only to measure the taxpayer's income apportionable to the State. The tax is thus allegedly imposed only upon the taxpayer's income and not upon the income of the other members of the group. This, of course, is an elevation of form over substance; in reality, the tax is imposed on an allocated portion of income of all members of the group.

California and other States have continually broadened the concept of "unitary business" in the last thirty years, with the result that affiliated corporations all over the United States and the world have become increasingly subjected to the indirect long-arm bookkeeping requirements and tax gathering mechanism predicated on the unitary business concept.

The late Dr. Laurence N. Woodworth, then Assistant Secretary of the Treasury, thoroughly analyzed the California system in the Hearings on the U. S.-U. K. Treaty, as follows:

> California tax authorities appear to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must be included in a combined report to the tax authorities.
>
> The combined report is, in effect, a consolidated return of the controlled group's worldwide income, although separate returns may be made for each member of the group. California apportions income to the state on the basis of the proportions which the California assets, sales and payroll bear to the worldwide assets, sales, and payroll of all the related companies.*

In describing its effect in the international context, Dr. Woodworth stated:

> I would note that the arm's-length standard is the internationally accepted norm for apportioning income between related taxpayers. It is confusing to other countries and disconcerting to international relations when our states use a different standard. Furthermore, the use of a different method by one jurisdiction will often lead to double taxation. We recognize that the purpose of the unitary system is not to tax the income of the foreign corporation included in the group, but the effect, nevertheless, is often extra-territorial taxation.*

Dr. Woodworth responded to the California arguments that they would lose revenue with the unanswerable point that --

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* Hearings, supra p. 2, at 32-33 (emphasis added).

> If, in fact, there is a substantial revenue loss when an arm's-length pricing standard replaces unitary apportionment, this may be an indication that unitary apportionment, does, in fact, result in unjustifiable extraterritorial taxation.

It is against this background that prior Congressional action on State use of the worldwide unitary apportionment system should be considered.

A. Burdens on Interstate Commerce

In the early 1930's Congress showed some concern over the States' increasing threat to interstate commerce when bills were introduced in both the House and the Senate to eliminate the difficulties in allocating taxes of multistate business. None were adopted. Thereafter, Congress shied away from considering Federal standards for State taxation, even though various groups within Congress strongly believed that the issue should be considered and resolved at the national level. As State interference in the workings of the national common market intensified, the large majority of tax policy experts concluded that Congress would ultimately have to resolve the issue of state taxation of interstate commerce.

Many experts argued that Congress had a duty to remove all State impediments to the free flow of commerce among the States. Others insisted that the States cannot realistically be expected to agree on the substance and scope of uniform rules, setting aside local rules for national ones. Furthermore, it was suggested that Congress was the only political body having sufficient authority to deal with the problem in an adequate manner. The principal evils to be addressed by Congress in the effort were the great degree of uncertainty about what the States would be allowed to tax, the high administrative costs to the taxpayer in complying with State law, and the inequity created in the aggregate by undertaxation in some situations and overtaxation in others.

In 1959, the Supreme Court decision in Northwestern States Portland Cement Co. v. Minnesota, 355 U. S. 911, brought to a head fears about State taxes overreaching reasonable limits. The Supreme Court held that a State can constitutionally impose what the Court called a nondiscriminatory, fairly-apportioned net income tax on a foreign (out-of-state) corporation engaged exclusively in interstate commerce in the State. The Court, however, in that case and subsequent cases has generally refused to determine whether such a tax is indeed non-discriminatory and fairly-apportioned. The outcry from regional and national businesses changed Congressional inertia into action, and within seven months Congress enacted Public Law 86-272 (15 U.S.C.A. §381). The new law, called the Interstate Income Act, restrained the States from imposing a tax on an out-of-state corporation on income derived within the State from interstate commerce, if the only business activities within the State are -- (1) the solicitation of orders which are approved or rejected outside the State and filled by delivery to a common carrier from outside the State, and (2) sales within the State by independent contractors.

Title II of Public Law 86-272, as amended, provided for a study of this entire matter by the Committee on the Judiciary of the House of Representatives and the Committee on Finance of the Senate, and for a report, together with their proposals for legislation, on or before June 30, 1965.

The study authorized by Public Law 86-272 was conducted by a subcommittee of the House Judiciary Committee; the chairman was Congressman Edwin E. Willis. The report, entitled State Taxation of Interstate Commerce, was published in four volumes during 1964 and 1965 as H. Rep. No. 1480, 88th Cong., and H. Rep. No. 565, 89th Cong. Volume 4, beginning with page 1117, contains the legislative recommendations of the Committee on the Judiciary. On the division of income among the States, the Committee recommended a formula apportionment composed of property and payroll factors, without the use of a sales factor. This formula was to be used without the use of specific allocation or separate accounting. The report stated on page 1155 that the "unitary business" rules provide vague and sometimes unevenly-administered standards for determining when the income of a multicorporate enterprise should be treated as a whole.

B. Particular Federal Responsibility For Foreign Commerce

The Willis Subcommittee devoted particular attention to the attempt of States to tax corporations which operate outside the United States:

> In keeping with the basic structure of our Federal system, the Committee is of the view that international tax policy should be formulated by the Federal Government and not by individual States. Therefore, with respect to income earned by corporations which operate either wholly or partially outside of the United States, the Committee recommends that State apportionment rules be required to conform to the international policies that have been formulated for Federal income tax purposes.
>
> Thus, if the immunity of any income from taxation by the United States results from its being considered to be from sources outside the United States, such income could not be attributed to any State of the United States. Likewise, no State would be allowed to require that such income be included in the consolidated income of a multicorporate enterprise for apportionment purposes. These prohibitions apply to corporations incorporated outside of the United States and are designed to eliminate inconsistencies which currently exist between Federal policy and the practice of a few States.
>
> At the same time, if a corporation is considered to have income from sources outside the United States and that income is taxable by the United States, such income could be included in a State's tax base prior to apportionment and the State would not be required to include property or payroll located outside the United States in its apportionment formula. These rules would apply to corporations incorporated in the United States and are designed to make available for apportionment among the States all of the tax base available to the United States.

The Committee's recommendations, including the recommendation to exclude the foreign source income of a foreign subsidiary, were incorporated in the proposed Interstate Taxation Act (H.R. 11798, 89th Cong. (1965)).

Section 202(2) of the bill prohibited any adjustment by a State to the Federal taxable income base if --

> it would include in the entire taxable income of a corporation not incorporated in any State any income which under the Internal Revenue Code of 1954 is not taxable by the United States as a result of being considered to be from sources without the United States or as a result of being otherwise connected or associated with or attributed to activities or occurrences without the United States.

Later, during the course of Congressional consideration of bills resulting from the work of the Willis Subcommittee on February 4, 1969, Senator Ribicoff made the following statement (115 Cong. Rec. 2597) when he introduced S. 916, 91st Cong., which embodied H.R. 2158, 90th Cong., with amendments:

> A major objection to the unitary concept is that the California practice requires the inclusion in unapportioned tax base of "foreign source income" which is earned in countries outside of the United States and which is not even included in the measure of the Federal income tax imposed by the United States. For example, under the California practice, a Connecticut corporation -- with an affiliate in California and other affiliates in such countries as Holland, France, Japan, and so forth -- is required to include in the measure of the California tax the income of the foreign affiliates as well as the income of the California affiliate and the Connecticut affiliate. Besides being highly inequitable, this practice conflicts directly with international tax policies of the Federal Government and, if permitted to continue, can result in a situation in

> which various States of the United States are formulating their own international tax policies without taking into account the international trade policies of the Federal Government. (Emphasis added.)

C. House-Senate Split On Congressional Action

H.R. 11798 was rewritten and reintroduced as H.R. 16491, 89th Cong. (1966), which in turn was replaced by H.R. 2158, 90th Cong. (1967). H.R. 2158 passed the House by an overwhelming margin but was not considered in the Senate. The bill was again introduced as H.R. 7906, 91st Cong. (1969), which passed the House but was not considered in the Senate. It was again introduced as H.R. 1538, 92nd Cong. (1971). Two other comparable but different bills were S. 317, 92nd Cong. (1971), introduced by Senators Mathias and Ribicoff, and S. 1883, 92nd Cong. (1971). None of these were enacted.

When he introduced S. 983, 96th Cong., on April 23, 1979, a date occurring before the Hearings on the Third Protocol to the proposed U. S.-U. K. tax treaty, Senator Mathias called attention to the series of bills on the interstate problem which he had introduced over the years, including S. 2080, 94th Cong., and S. 2173, 95th Cong. He noted that the Senate Finance Committee created a Subcommittee on Interstate Taxation in the 93rd Congress (chaired by then Senator Mondale) and that the House Ways and Means Committee directed the General Accounting Office in the 95th Congress to study State and Federal approaches to the taxation of multistate and multinational corporations (Cong. Rec. daily ed. April 23, 1979, S4464).

As previously stated (page 5), when the Ways and Means Task Force on Foreign Source Income considered the matter, they recommended legislation as reflected in H.R. 5076. Surely in light of this history of prior Congressional action, Congress will act again to impose reasonable standards on the States to protect the foreign commerce of the United States.

V. Clear and Present Need To Meet U. S. International Obligations

While there may be some theoretical justification for the unitary approach with respect to income earned within a homogeneous economic system, such as the United States, the unitary concept begins to lose whatever integrity it has when foreign income arising in different economic systems is taken into account. It surely loses its integrity when it reaches out and takes into consideration the income of a foreign parent of a U.S. subsidiary doing business in a State when that foreign parent does no business in, and has no connection with, the State. It becomes particularly arbitrary and unreasonable when it takes into account the income of a foreign-based group from all over the world, including income of separate corporations which may be only 51% owned, which have no connection with the United States, and which may be operating in totally different economic and social systems which cannot be compared to operations in the United States (infra pp. 57-61). The effective result is that the State thereby collects taxes based on foreign income in contravention of well-established international standards of taxation, inconsistent even with the manner in which the United States itself determines income subject to tax.

The States argue, without substance, that they are not in fact taxing the foreign-source income of the related foreign corporations, but are simply taking that income into account in order to determine only the tax measured by the net income derived from, or attributable to, activity within the State. It is clear, however, that in such a case, the State has injected its State taxation system into multiple foreign operations of multinational corporations having no immediate, direct contact with the State. The substance of the matter is that it is in fact requiring a consolidated return and taxing the foreign entities of the group. This excursion into foreign activities is at variance -- (1) with the rules adopted by the U.S. Congress in 1928; (2) with all the many income tax conventions which the United States, as a matter of international policy, has entered into since 1932; (3) with all the many treaties of Friendship and Commerce which, as a matter of international policy, the United States has negotiated since 1946, and; (4) with the Model Double Taxation Convention on Income and Capital of the Organisation for Economic Co-operation and Development of which, as a matter of international policy, the United States is a member.

A. Federal Supremacy As To Foreign Commerce

This method of taxation by a separate State of the Union clearly seems to be activity affecting directly the commerce of the United States with foreign nations. Article I, section 8, clause 3, of the U. S. Constitution provides that only the Congress of the United States shall have power to regulate commerce with foreign nations and among the several States. If the United States Congress has taken the position that it alone has the power, through such acts as Public Law 86-262, to provide uniform standards for application of the unitary business concept to commerce among the several States, it necessarily follows that it has the power and indeed the duty to provide standards for the application of the unitary business concept to commerce between the United States and foreign countries.

The supremacy of the national power and Federal laws in the general field of foreign affairs is clear:

> That the supremacy of the national power in the general field of foreign affairs, including power over immigration, naturalization and deportation, is made clear by the Constitution was pointed out by the authors of The Federalist in 1787, and has since been given continuous recognition by this Court. *When the national government by treaty or statute has established rules and regulations touching the rights, privileges, obligations, or burdens of aliens as such, the treaty or statute is the supreme law of the land*. No state can add to or take from the force and effect of such treaty or statute, * * * (underscoring supplied). *Hines v. Davidowitz*, 312 U. S. 52 (1941).

In Moorman Manufacturing Company v. Bair, 437 U. S. 267 (1978), the Supreme Court held that Iowa's application of a single factor formula to an Illinois corporation, which was based on gross sales, was not invalid even though there was an overlap in taxation by reason of the application by Illinois of its three-factor formula, which was based on property, payroll, and sales, to the same corporation. The Court pointed out:

> While the freedom of the states to formulate the independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected states. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income. It is to that body, and not this court, that the Constitution has committed such policy decisions.

In Japan Line, Ltd. v. County of Los Angeles, 60 L. Ed. 2d 336 (April 30, 1979), the Supreme Court held that political subdivisions of California were prohibited by the Commerce Clause of the Constitution from imposing a nondiscriminatory apportioned ad valorem property tax on foreign-owned cargo containers that were exclusively in international commerce but temporarily in the State. The tax prevented this Nation from "speaking with one voice" in regulating foreign trade and thus was inconsistent with the Federal power to regulate commerce with foreign nations. Unfortunately, in the more recent Mobil Oil Corp. case, the Supreme Court refused, in effect, to extend the protection against unduly-burdensome State taxation of foreign source income reflected in the Japan Line case; the Court squarely places the responsibility for imposing limitations on State taxation of foreign source income upon Congress, and the Finance Committee should shoulder that responsibility.

The following excerpts from the Japan Line decision are, however, entirely relevant to the matter now before this Subcommittee:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates any asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.
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> * * * * * *
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> * * * a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the

> Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.
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> * * * * *
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> * * * Appellees' argument, moreover, defeats, rather than supports, the cause it aims to promote. For to say that California has created a problem susceptible only of congressional -- indeed, only of international -- solution is to concede that the taxation of foreign-owned containers is an area where a uniform federal rule is essential. California may not tell this Nation or Japan how to run their foreign policies.

B. Potential Retaliation By Foreign Nations -- Code §§891, 896

The Japan Line case invites attention to potential foreign retaliation to State taxation of income arising outside the United States by various arbitrary methods of apportionment. This retaliation may arise either as a result of the nature of the income included (completely unrelated to activities within such state) or to unfair apportionment formulas.

Potential reverse retaliation by the United States became a reality in 1934 when the converse of the unitary business concept in modified form was applied by France against U. S. corporations in the 1920's. Taking the position that a French subsidiary corporation was the emanation pure and simple of its U.S. (or other non-French) parent corporation, France was assessing tax on dividends paid by ch U.S. parent corporation in the proportion that its sets in France bore to total assets. When efforts were made o persuade the French to desist, the French insisted on egotiating a bilateral income tax convention with reciprocal oncessions, thereby establishing a precedent for negotiations ith other governments. The convention was signed on April 7, 1932 (TS 885, 49 Stat. 3145). It provided that any profits iverted from the French subsidiary to the American parent ould be included in the taxable profits of the French subsidiary and also treated as a taxable dividend. In the case of a French branch of a U. S. corporation, any profits that were diverted to the home office would be subject to French tax as industrial or commercial profits; in addition, three-fourths of these profits would be subject to tax by France as a dividend.

When France delayed in ratifying the convention of 1932, the U. S. Congress adopted section 103 of the Revenue Act of 1934 (now section 891 of the 1954 Code). It was in effect a retaliation by the United States against France for the extraterritorial tax France had been assessing against U. S. corporations; it demonstrates, however, the type of measure that is available to foreign countries to use in retaliation against the United States for its failure to eliminate or control, as a matter of international tax policy, assessments of any States using the unitary business method against foreign nationals.

Section 103 of the 1934 Act, which was approved on May 10, 1934, provided that whenever the President finds that U. S. citizens or corporations are subjected to discriminatory or extraterritorial taxes by a foreign country, citizens or corporations of that country are, pursuant to his proclamation, to be subjected to U. S. taxes at double the rate ordinarily applicable. The House bill on the 1934 Act was leveled only against foreign discriminatory taxes. The Senate extended the provision to extraterritorial taxes and made the following comment in S. Rep. No. 558, 73d Cong., 1939-1 (Part 1) C.B. 586, 610:

> In the first place, the section is made to apply if the foreign country levies extraterritorial taxes, as well as discriminatory taxes. Thus, a tax on income not properly within the jurisdiction of the foreign country imposing such tax will come within this classification. In the second place, the rate of tax is increased from 50 per cent to 100 per cent. It appears that a 50 per cent increase will be only an idle threat in some cases, due to the high taxes imposed by some foreign countries upon American citizens. However, to prevent actual confiscation of the foreigner's income, it is provided that this section shall not operate to increase the rate of tax imposed by other sections of the bill to an amount in excess of 80 per cent of the taxpayer's net income. * * *

This new provision of law was called to the attention of the French, who were thereby not unexpectedly persuaded to ratify the 1932 convention on April 8, 1935. Not long after the United States had prevailed upon France by this convention to give up its extraterritorial taxes, the Canadians persuaded the United States, in Article XII (as modified) of its income tax convention of March 4, 1942, with the United States (TS 983, 56 Stat. 1399), to give up the alleged extraterritorial taxes of the United States imposed upon dividends and interest paid by a Canadian corporation to other than citizens of the United States. This alleged extraterritorial tax arises by reason of §§861(a)(1)(C) and 861(a)(2)(B) of the Internal Revenue Code and their predecessors. An exemption corresponding to that agreed to by the United States in such tax convention with Canada was thereafter agreed to by the United States in many subsequent tax conventions with other countries.

Thus, the United States has already adopted legislation in retaliation against extraterritorial taxation by a foreign government. The provisions of §891, and the somewhat similar provisions of §896, may still be used by the United States against a foreign country, except to the extent their application would be contrary to any treaty obligation of the United States in effect on August 16, 1954, as provided in §7852(d) of the Internal Revenue Code.

C. Arm's-Length Principle Adopted In Tax Treaties

The fundamental principle adopted in §482 of the Internal Revenue Code is that income is to be determined on a separate accounting or separate enterprise basis governed by the requirement that all intercompany dealings between related parties must meet the arm's-length standard. This arm's-length concept was adopted in the first income tax convention to which the United States was a party, i.e., that with France signed April 27, 1932, Article IV, TS 885, 49 Stat. 3145. There was no technical explanation of the Article. The second income tax convention to adopt the arm's-length concept was that with Sweden signed March 23, 1939, Article III, TS 958, 54 Stat. 1759. The report of the Senate Committee on Foreign Relations (Ex. Rep. No. 18, 76th Cong., 1st Sess., 7) on the convention with Sweden stated:

> Article III is of material importance, in that it recognizes the principle of rectification of account; as between a corporation in one of the contracting states and its related, but not necessarily its subsidiary, company operating in the other contracting state. While a subsidiary company is considered a separate and distinct entity for the purposes of the permanent establishment theory, it is included within the scope of article III which, like section 45 of the Revenue Act of 1938, recognizes the necessity of adjustments as between interlocking businesses. From the combined effects of articles II and III, it is contemplated that there shall be complete power of rectification in the field of business income.

Consistent with this first beginning, in nearly forty income tax treaties which the United States has since negotiated, this separate accounting, separate enterprise, arm's-length principle has been adopted as a keystone, and a comparable provision is contained in Article 9(1) of the new income tax convention with the United Kingdom. Thus, this international stance of the United States as a nation has been consistently maintained for at least forty-eight years.

D. Obligations Under Treaties Of Friendship And Commerce

Since 1946 the United States has entered into about twenty-five treaties of friendship and commerce with foreign nations. Each of these treaties contains mutual restrictions on taxation that are consistent with, and based upon, the Federal system of income taxation of foreign corporations in the United States.

Under §882(b) of the Internal Revenue Code, the general rule is that only the income of a foreign corporation from sources within the United States is taxed. (In a very rare case certain limited amounts of income from sources without the United States are included (§864(c)(4)), but only if the foreign corporation has fixed place of business in the United States to which such income is attributable). In limited circumstances the Federal Government imputes income, as though it were a constructive dividend, of a foreign corporation to its U.S. shareholders, but these are special situations (sections 551, 951, 1246, 1248) in which the foreign income is taxed to the U.S. shareholders based on their citizenship or residence in the United States. In none of these cases does the Federal Government include in income more than the U. S. shareholder's ratable share of the particular corporation's income. If the foreign corporation is not engaged in business in the United States, §881 of the Internal Revenue Code imposes a flat tax only upon certain enumerated items of income from sources within the United States (fixed or determinable annual or periodical income); if the foreign corporation is engaged in business in the United States, the flat tax is imposed upon the same items of income if they are not effectively connected with the business and, in addition, §882 of the Code imposes the regular corporate tax upon the income which is effectively connected with the business. In no case, however, does the Internal Revenue Code apportion income on an arbitrary basis.

The first of the post-World War II treaties of friendship and commerce was that with China, signed November 4, 1946 (TIAS 1871, 63 Stat. 1299). Article X(1) provides in effect that: (1) a Chinese corporation that is engaged in business within the territory of the United States shall not be subject to the payment of any internal taxes, fees, or charges other or higher than those which are, or may be, imposed upon U.S. corporations; and (2) the taxes, fees, or charges of such a Chinese corporation shall not be imposed upon or measured by any income, property, capital, or other criterion of measurement in excess of that reasonably allocable to, or apportionable to, the territories of the United States. Significantly, in the same month that this treaty was signed, the Fiscal Committee of the League of Nations issued its report on the League's Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property.

Article IV of that Model provided that a corporation of one Government ("State") would not be taxed by the other Government ("State") unless it was engaged in business in the other State through a permanent establishment and that, if it were so engaged, the other State could tax only that part of its income which is produced in the other State as an independent establishment. Article XV of that model (Article XVI of the London Draft) provided that a taxpayer with a fiscal domicile in one State could not be subjected in the other State "in respect of income he derives from that State" to higher or other taxes than those applicable to the same income of a taxpayer with his fiscal domicile in the other State. In the case of a corporation, fiscal domicile was defined by Article II(4) of the Protocols to be the State where the center of management is situated. The Commentary of the Fiscal Committee on the League's Model (page 31) makes it unequivocally clear that Article XVI of the London Draft was intended also to apply to taxes on property, capital, or investment of wealth.

Thus, in the context of the League's then very current Model and of the language itself of Article X(1) of the treaty of friendship with China, the United States agreed not to impose an income tax upon a Chinese corporation not engaged in business in the United States, and to treat any subsidiaries of such a Chinese corporation doing business in the U.S. as an independent enterprise.

All of the treaties of friendship and commerce subsequently entered into by the United States contained some version of the concept adopted in the treaty with China, but some were more categorical than others. Two deserve special mention. Article XVI(3) of the treaty with Greece signed

August 3, 1951 (TIAS 3057, 5 UST 1829) provides that, in the case of a company of either Party engaged in trade in the other Party, the other Party shall not impose or apply any tax, fee, or charge upon any income, capital, or other basis in excess of that reasonably allocable or apportionable to its territories. This provision was the one more commonly used in the treaties of friendship and commerce. The most detailed provision is Article IX(4) of the treaty with France signed November 25, 1959 (TIAS 4625, 11 UST 2398), which provides that companies of either High Contracting Party engaged in trade or other gainful pursuit within the territories of the other shall not be subject, within the territories of the other High Contracting Party, to any form of taxation upon capital, income, profits, or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are engaged, the transactions which they accomplish there, or any other bases of taxation directly related to their activities within those territories. The concept adopted by all of the treaties of friendship and commerce is essentially the same in this context, that is, separate accounting/separate enterprise treatment whereby only the income of the entity or entities within the group doing business in the country may be taxed by that country, and even then only on the income attributable to such activities within the country reasonably allocable or apportionable to such activities.

The purpose of this provision of the treaties of friendship and commerce appears in the memorandum of the State Department explaining the provision (Art. VII) of the treaty with Muscat and Oman signed December 20, 1958 (TIAS 4530, 11 UST 1835). That memorandum, contained in Sen. Ex. Rep. No. 1, 86th Cong., 1st Sess., 5, states in part as follows:

> It also provides that companies of either party shall be taxed by the other only on income, transactions, or capital allocable or apportionable to their operations in the territories of the latter. These rules of nondiscrimination reflect principles embodies in U.S. tax law. (Emphasis added).

When the proposed friendship and commerce treaties with Colombia, Israel, Ethiopia, Italy, Denmark, and Greece were being considered at the Hearing on May 9, 1952, before a Subcommittee of the Senate Committee on Foreign Relations, Harold F. Linder, Deputy Assistant Secretary of State for Economic Affairs, stated —

> They do include a guaranty that we will not be taxed in any country, and no American corporation will be taxed, beyond the activities of that corporation with the country. That is to say, if a large American corporation has a subsidiary operating in a foreign country, the only thing the foreign country can tax is the business that is conducted within its territory. * * *
>
> Furthermore, we do have provisions which will insure that we will not be taxed, or our corporations will not be taxed, beyond the tax that is enacted by that government and affects its own nationals, and also we have the guaranties with respect to most-favored nation.

Although California may say, for example, that the use of the foreign income of related enterprises having no direct contact with the United States is taken into account under the unitary business concept solely as the measure for determining the income from sources within California of the related corporation engaged in business in California, it is evident that as a matter of substance, California is thereby burdening the foreign income with taxation. The use of such a concept is completely contrary to the separate accounting concept adopted by foreign nations and by the treaties to which the United States is a party.

E. International Tax Standards Call For Arm's-Length Separate Accounting

Both the Mexican Draft and the London Draft of the Model Bilateral Tax Convention on Income and Property of the League of Nations adopted the separate enterprise, arm's-length concept in Article IV, as supplemented by Article VI of their Protocols. The Commentary of the Fiscal Committee of the League of Nations, dated November, 1946, states on page 18 that the method of determining or allocating the profits attributable to a permanent establishment of a foreign enterprise in a country "is known as the method of separate accounting." The intent was expressed "that each establishment or branch is taxed as if it constituted a distinct independent enterprise and the profits of the establishment are assesed independently of the results of the business done elsewhere by the enterprise to which it belongs." (Underscoring added). The Commentary contains approximately five pages of discussion of the separate accounting concept and related alternative techniques to be used in appropriate circumstances.

Articles 7 and 9 of the 1977 Model Double Taxation Convention on Income and Capital of the Organisation for Economic Co-operation and Development, as contained in the 1977 report of the OECD Committee on Fiscal Affairs, also provides for adoption of the separate enterprise, arm's-length concept. Article 7 deals with the taxation of profits attributable to a permanent establishment (e.g., a branch) in one of the States, and Article 9 deals with the determination of the profits of an enterprise of one of the States related to an enterprise of the other State. Analysis of the Commentary on these two articles discloses nothing that would permit taking into account income of an enterprise other than the income of the enterprise of one State which has a permanent establishment in the other State or, where an enterprise of one State deals with an enterprise of the other State, that would permit taking into account income of a third enterprise.

The following excerpts from the Commentary on Article 7 are relevant:

> Article 7(1) restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say

> that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.
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> * * * But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test.
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> * * * In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course - reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial

processes, and so be out of keeping with the aims of the Convention.

* * * It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

* * * There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits.

The Commentary on Article 9 contains the following:

This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made

> or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).

The Council of the OECD in July, 1979, adopted a recommendation for uniform, worldwide use by countries of the separate accounting, arm's-length principle, rather than any formula apportionment method. This was based on a 100-page report setting out a number of methods of establishing "acceptable price levels" for determining intercompany arm's-length prices, in which it is clear that the United States Treasury Regulations under §482 were given close attention. The OECD action reflects the consensus of the Governments who are members of the OECD, including the United States, that separate accounting employing arm's-length standards is the only appropriate system for taxation of international transactions. See Transfer Pricing and Multinational Enterprises (OECD, Paris, July 1979).

F. Protection of U.S. Companies Abroad

While the United States can, for the most part, protect U.S. companies from excessive foreign taxation only through the treaty process, Federal legislation should provide a sound foundation for that protection. Once international tax policy standards for the Nation as a whole have been established through the Federal legislative process, the desired reciprocity can be achieved later through the treaty-making process or through punitive legislation adopted by

Congress which will impose sanctions upon any foreign government that balks at granting mutuality to U.S. corporations. The precedent, discussed above, for such an approach is clearly established through development of the separate accounting, arm's-length concept first adopted by Congress in the predecessor of §482 in the Revenue Act of 1928 by -- (1) the incorporation of the concept into the income tax convention of 1932 with France; (2) the adoption in 1934 of the punitive statutory provisions of the predecessor of §891; (3) the gradual adoption of the principle by other countries vis-a-vis the United States in the model income tax convention of the League of Nations; (4) the incorporation of the concept into the many income tax conventions to which the United States has become a party since 1932; and (5) the use of the principle in the 1977 Model Income Tax Convention of the Organisation for Economic Co-operation and Development, of which the United States is a member.

This at the very least demonstrates the need to conform State rules to the Federal rules with respect to the international tax policy of the Federal Government. The protection of U.S. industry from unreasonable foreign tax burdens requires a combination of Federal legislation and the use of the treaty power of the Federal Government. The two approaches are complementary. Federal legislation is necessary to establish a reasonable tax system in the United States for foreign corporate groups. This requires limiting the use of the unitary business concept by the

States so as to exclude foreign income of foreign corporations and their subsidiaries until such income is taxed by the Federal Government itself. This in turn then fully justifies provision in a treaty (or punitive legislation) to protect U.S. businesses from the use of the concept by foreign countries, but such protection is not justified if the States of the United States themselves do not conform to international tax standards.

S. 1688 provides an appropriate standard whereby the United States in its own interests would establish a very reasonable kind of limitation upon the use of the unitary business method by the various States. If the States continue their treatment of foreign-owned corporate groups, U.S. companies may suffer retaliation by other countries (and their political subdivisions) in which they do business. The United States itself, of course, will bear a large part of the burden of such foreign country actions, because increased foreign taxes may result in decreased U.S. taxes by reason of the foreign tax credit. In such a situation it would be virtually impossible as a matter of principle to invoke the use of §891 of the Code, since the foreign action would simply be in retaliation for the method followed by the States.

Of even greater concern, other foreign countries, particularly developing countries, may adapt the unitary business concept in particular ways to impose greater tax burdens on U.S. companies. In one case, a developing country not long ago attempted to tax airline and shipping companies (but not other companies) by allocating worldwide income of such companies, and all companies related to them, based on the relationship of passenger and freight revenues. This would have been an allocation based in major part on one allocation factor, sales; if plant and payroll had also been given weight, the allocation would have been less. Furthermore, in practical effect, the result was to increase the tax burden of only one taxpayer, a U.S. shipping company which actually had a loss from operations. Because, however, such U.S. company was a subsidiary of a much larger group of U.S. controlled companies engaged in many different businesses throughout the world, the result was to allocate a large amount of taxable income to that foreign country. Thus, the unitary business concept in practical effect would have reached only one company, a U.S. company, and would have created income subject to tax even though the shipping operations of the U.S. group had resulted in a loss.

Fortunately, the result was so extreme that the courts of the foreign country in question struck down the effort. The attempt by the foreign government almost succeeded, however, and there is no assurance the courts of other countries will react in the same favorable way to U.S. companies. The United States can protect itself from such extremes by adopting legislation of the type proposed in S. 1688 and then using treaties or §891 of the Code to prevent foreign countries from attempting to impose unreasonable tax burdens in this manner on U.S. companies.

If the unitary business concept spreads to other countries, U.S. companies may be forced to provide confidential financial information and other data, just as the State method seeks from foreign companies. Consider the impact of an unfriendly nation insisting upon details as to U.S. plant costs, U.S. research and experimental expenses, and other such information from a U.S. company with extensive defense production of secret products, or one engaged in nuclear reactor construction. The provision of such information may be contrary to an entire series of U.S. laws, just as the provision of information to any of the States of the U.S. may violate the laws of various foreign countries in the world in which a foreign-controlled corporate group may be doing business.

G. Existing Urgency For Federal Action

There is considerable urgency for action by this Committee on S. 1688 to avoid potential excessive foreign taxation of U.S. enterprises abroad. Because of the Senate's action on Article 9(4) in the U.S.-U.K. treaty, foreign governments all over the world are extremely sensitive to the burdens being imposed on their companies by States such as California. States other than California, Oregon, and Alaska have moved toward extending their unitary systems to include more and more foreign source income, and the Supreme Court's decision in the Mobil Oil Corp. case could accelerate this trend.

Federal legislation affecting the application of the unitary method by the States to corporations engaged in interstate commerce has been under consideration at various times for at least fifteen years, and more than one bill has died in the Senate even though passed by an overwhelming majority in the House. Foreign countries certainly will not patiently wait out such a protracted process of development before they turn to potential retaliation, assuming they are not prohibited from retaliation by the treaties of friendship and commerce, and the income tax conventions, which they have entered into with the United States. But if these treaties do in law already prohibit retaliation by any foreign country, then a fortiori they prohibit the use of the unitary business method by any State of the Union against enterprises of such countries.

There is a clear and present need for Congressional action to meet international obligations of the United States to prevent unreasonable tax and administrative burdens in foreign-owned corporate groups with U.S. operations and to provide a firm foundation for protection of U.S. business operations abroad against retaliatory foreign taxation.

VI. Fundamental Invalidity Of Unitary Apportionment Of Worldwide Income

The past operation of the unitary business concept applied by a State such as California to a U.K. group of corporations demonstrates vividly why S. 1688 or Federal legislation with similar objectives is so necessary. If the United States is to continue to be a world leader supporting free trade in the international market, Congress should be the leader in establishing Federal standards for State taxation of foreign source income that achieve a fair and reasonable system in which States tax only the income that has some relationship to activities within those States.

There may be some theoretical merit to the use of the unitary business method to allocate income realized within a homogeneous economic structure, such as its application with respect to all income from U.S. operations. It is not justified, however, where it allocates differing kinds of foreign income realized by a foreign-based group of corporations from all over the world.

As previously stated, beginning in the early 1970's, California sought (retroactive to all prior open years) to extend its unitary business concept to include the foreign parent of a U.S. subsidiary of a foreign-controlled corporate group and all other foreign corporations in the group throughout the world. As a result, California sought to allocate the worldwide income of a foreign-controlled corporate group, including income of members which did no business in California and had no connection with California. Oregon and Alaska followed California's lead in more recent years.

Furthermore, while giving lip service to the concept that there must be more than mere unity of ownership (50% or more common ownership within the group), California as a practical matter all but abandoned the concept that there must be unity of operation as well. Actions by the California tax authorities made this clear; California attempted to apply the unitary business method to every foreign-controlled corporate group, any member of which was doing business in California, even though other members of the group had no relationship to California. California, in effect, abandoned whatever rationale existed for the unitary business method in these cases. In a speech in June, 1974, the former Counsel of the California Franchise Tax Board, Frank M. Keesling, who takes a large measure of credit for instituting in California the apportionment of income under the unitary business concept, made the following statement:

> Now that I am older if no wiser, I question whether there is such a thing as a non-unitary business. Although I still believe that it is appropriate to compute non-business income separately and to allocate it specifically, I am inclined to the view that all income from commonly-owned business activities should be combined and apportioned by a single formula without inquiring as to whether such activities are unitary or separate in nature. Such a policy is simple to administer and will promote uniformity.

Dr. Woodworth's analysis (supra, p. 20) recognized that as applied in California, there are virtually no limits on unitary apportionment of worldwide income.

This newly-developed practice in California, Oregon, and Alaska has been met with astonishment and uniform objection and resentment by foreign-controlled corporate groups with U.S. business operations. This occurs because the effects of the California unitary business method are so extreme in overstating income of foreign-owned corporate groups allocable to California, because the California unitary business method imposes such unreasonable (even impossible) administrative burdens on foreign worldwide groups in determining and stating "income" by California standards, and because it is so contrary to international tax principles.

This international concern is reflected in the resolution adopted by the International Chamber of Commerce on September 26, 1979, following an analysis of the effects of the California system:

> The ICC views with concern the inevitability that an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations, will result in mounting double taxation of profits (which tax treaties set out to avoid). This is particularly so if the basis of assessment in any such political sub-division is not entirely consistent with that of the country itself and extends to operations carried on outside the country. This problem has manifested itself in an acute form in connection with the attempts of the State of California to impose the "global" or "unitary" form of assessment based on income of companies involved in international operations outside the U. S.
>
> The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would otherwise have been undertaken. This approach, if it should spread, could easily become a most important threat to international trade since international operations would inevitably be confronted with a real danger of multiple taxation of the same profits and unacceptable administrative burdens. The dangers were also recognized by the Council of the OECD in rejecting the so-called "global" method in its recent report on Transfer Pricing (Transfer Pricing and Multinational Enterprises (OECD, Paris, July 1979) pp. 14-15).
>
> The ICC reconfirms its view that, as a general rule, tax should be based on a fair measure of income as computed by reference to the amount

> which could be expected to arise between independent parties dealing at arm's length. This rule has universal application. The ICC therefore recommends that, in all cases where the taxation policies of political sub-divisions extend to non-domestic operations, all possible measures should be taken to ensure that the terms of an agreement or treaty dealing with taxation on income should bind all authorities having jurisdiction within the boundaries of each contracting State. This recommendation is in accordance with the OECD model taxation Convention 1977 (Art. 2) and a considerable number of international friendship, trade and shipping treaties. (Doc. No. 180/195 Or. Rev., International Chamber of Commerce, Paris, 1979-10-01).

There are two fundamental reasons why the unitary business method should not be applied with respect to income of a U.K. parent or affiliated companies in third countries where such parent or affiliated companies are not doing business in the United States. First, such a foreign-owned and foreign-based corporate group is likely to have operations all over the world, in both developed and developing countries. Most or all of the United Kingdom groups with U.S. subsidiaries doing business in California fall into this class. The United Kingdom historically has depended upon world trade, and U.K. businesses traditionally reach into every corner of the world as an outgrowth of the former size of the British Empire itself.

This means that a unitary business method based on income from all such operations will necessarily allocate or apportion income based on payroll amounts, property costs, and sales which cannot fairly be compared. The result is to allocate a higher portion of total income to the location where these amounts are highest, relatively speaking, unless income bears the same relationship to costs throughout the world irrespective of the amount of such costs. As compared to the United States, profit margins vary widely throughout the world and bear no such uniform relationship to costs.

A. The Formula Apportionment Factors Are Invalid

The California system creates major distortions which tend to result in over-allocations of income to that State. California wages per hour are generally much higher than elsewhere in the world,* and even after allowance for capital intensity and productivity, the payroll factor tends to over-allocate income to California. California has refused to reduce the extent of this distortion by applying the payroll factor in terms of hours rather than dollar wages. California uses only payroll dollars in the payroll factor, excluding pension and other fringe benefit costs. These other labor costs are often higher in foreign countries with more extensive social programs than the United States; exclusion of these costs often over-allocates income to California.

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*/ Comparative per hour wage rates in dollars in 1979 were as follows in the countries indicated:

U.S.	$9.09	Japan	$5.58
U.K.	5.46	Brazil	1.80
France	8.17	Indonesia**	.65

** Data provided by United States Department of Labor, Bureau of Productivity and Technology. Amount for Indonesia is estimated.

Property costs are also substantially higher in California than elsewhere in the world, with the same distortive effect because of the application of the property factor. California also has stringent pollution control requirements, causing a relatively higher property investment per unit of production in that State without an equivalent increase in profits; in fact, such nonproductive property costs may reduce actual California profits. Again, the property factor thereby tends to over-allocate worldwide income to California.

Even the sales factor causes major distortions when income arising outside a homogeneous economic system is allocated. For example, B.A.T. Industries, a U.K. corporate group with extensive worldwide operations, has a U.S. subsidiary, Brown and Williamson Tobacco Company. The heavy U.S. Federal and State tobacco excise taxes are reflected in U.S. sales, without any proportionate increase in profit margins, causing an over-allocation of worldwide income to California pursuant to the sales factor.

California has ignored demonstrable differences in the relationship of profits to sales, also tending in some cases to over-allocate income to California. For example, Rickett & Colman Limited, a U.K.-controlled group, had diverse business activities all over the world. Its U.S. activities were limited almost entirely to its food and wine operations, which represented 44.4 percent of total group sales but only 30.3% of operating profits. The group's household and toilletry operations, which extended to the United States only to a very insignificant degree, represent only 35.1% of group sales but contributed 49.1% to the group's operating profit. Obviously, an allocation of group profit to California based on sales allocates far too large a share of group income to California. This point was made by Rickett & Colman Limited to the California authorities, but they rejected it.

B. Profits Do Not Bear A Uniform Relationship To Factors

California has allocated worldwide profits without adjustment for other demonstrable differences. For example, profits in developing countries may be much higher in relation to costs in order to reflect greatly increased risks of expropriation, currency exchange limitations, or other such factors. The result may be to allocate part of this risk profit, which is really a contingency reserve, to California. California allocates worldwide income even when such income includes substantial profits in foreign countries which are blocked and which for this reason would not be subject to U.S. Federal tax in the case of a U.S. taxpayer until they become unblocked. California has even applied its unitary business method to allocate income to California when it is demonstrable beyond reasonable question that actual operations in California have resulted in a loss. Even where a combined return for an entire corporate group shows a net loss for a group, California has required payment of a minimum tax on corporations by each corporation in the group that is incorporated, or qualified to do business, in California.

It is no answer that these or other considerations may in particular cases work in reverse to under-allocate income to California. The real point is that the extension of the unitary business method to allocate income which includes income arising outside a homogeneous economic system, such as the United States, almost certainly introduces major distortions. These distortions would not arise under the alternative application of the separate accounting, arm's-length standard of §482 as it is rigidly enforced by the Internal Revenue Service. It is also true, however, as suggested above, that California's conventions in applying its unitary business concept have tended to over-allocate income to California.

The California system applied to worldwide income has also produced gross distortions because it allocates before-tax income, not after-tax income. Taxes imposed on income by governments throughout the world do not bear any uniform relationship to income and sometimes tend to be higher than in the United States. In any event, the California system has allocated to California a portion of worldwide before-tax net income (determined under California law) of a U.K. corporate group which has been subject to varying tax burdens in the many foreign countries where it has been earned. The result is almost certainly to produce a distortion in the amount fairly allocable to California. In other words, the result is that the California system may impose more tax as a percentage of after-tax income (the amount available to pay California tax) than the percentage which its nominal rate bears to actual after-tax U.S income of the group. The California system may thereby allocate to California that part of the income of the group that is required to pay taxes at higher rates than in the United States. In a sense, the California tax becomes a tax on a tax, or at least an income tax on income that has already been fully taxed and is required to pay the tax already imposed. Furthermore, the California system does not allow any credit against its tax for taxes paid to another State or to a foreign country, the presumption being that there is no double taxation of the income allocated to California. This is the plainest kind of extraterritorial taxation -- an unfairness that would be addressed by provisions of S. 1688.

C. Intolerable Administrative Burdens For Foreign Worldwide Corporate Group

There is a second major reason why it is reasonable to limit California's unitary business method in the case of a U.S. subsidiary of a U.K. corporation so that California may take into account only foreign income of the company doing business in California and its subsidiaries, and not income of other affiliated corporations within the U.K. corporate group which are not doing business in California. It is an unreasonable burden, if not an impossible burden, for a U.K. group not controlled by U.S. persons to provide the financial information to California that is required to make such a unitary computation. A U.K.-owned and U.K.-based worldwide group does not keep its books, or determine income, payroll, plant costs, and sales, in dollars, or by California accounting standards. The required conversion of financial figures to dollars at scores of different exchange rates, with sharp fluctuations, devaluations, and other changes, would be an operational nightmare for a foreign-based group with extensive international operations. It would also be a nightmare to convert the diversified accounting standards used by such a group into the accounting standards applied by California. California itself does not follow U.S. federal income tax accounting and other concepts in some respects. The cost of compliance with the California requirements in the case of a U.K. worldwide group might conceivably be far in excess of the California tax itself. It is also patently clear that an attempt to enforce these requirements is an extraterritorial extension of California law to foreign areas in which California has no jurisdiction.

For example, one foreign-controlled corporate group with extensive and diverse world-wide operations had roughly 3,000 separate taxable entities. The group estimated that full compliance with the California unitary business method could require administrative costs of $100,000 per year or more, as compared to real net income from California operations of $2,000,000 per year. The California unitary business method, however, allocates as much as $6,000,000 of net income per year to California. The California nominal corporate tax rate was 9%. Under these conditions, the combined effect of the unitary business method and the cost of compliance therewith raised the effective California tax rate to 32% rather than 9%.

Further, financial information may reflect confidential data, trade secrets, or important information that cannot be made available to governmental units having no connection with the companies involved. In the case of foreign affiliates not wholly-owned, it may be illegal under the laws of their country of incorporation to provide such information to third parties, such as California. This burden is clearly recognized in the report of the Task Force on Foreign Source Income of the House Ways and Means Committee.*

The recordkeeping necessary to facilitate full compliance with the California unitary business method would obviously place intolerable burdens upon a group of affiliated foreign corporations, particularly where there are diversities of language, currencies, foreign exchange, accounting methods, and accounting periods. Furthermore, there is the problem of compelling compliance with California rules and standards in order to show that all groups in like circumstances are treated on an equitable basis. The Journal of Commerce for June 8, 1977, contains a report of an interview with Tom Quinn, special assistant to Governor Brown of California. In this interview Mr. Quinn stated that the unitary tax law is "difficult to enforce and that it could invoke sending State auditors "all over the world". Under such circumstances, can it be denied that the application and enforcement abroad of California law is an extraterritorial extension of State law into the jurisdiction of a foreign government? A chaotic international situation could arise if the unitary business method applied by California (or sundry variations thereof) were to be adopted by all of the fifty States.

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*/ Supra, p. 5.

D. The Fifty-Percent Related Ownership Test Is Unreasonable

Finally, the California unitary business method imposes unreasonable burdens because it is applied wherever there is more than 50% intercompany control within the group without adjustment for the minority ownership. Assuming a constant 51% intercompany control, California law requires an allocation of the entire net income on a combined basis, notwithstanding the highly significant minority interest, which will insure arm's-length pricing and make formula apportionment of worldwide income entirely unnecessary. The California law makes no provisions for an allocation of a ratable share, as do such provisions as §§551, 951, 1246, and 1248 of the Internal Revenue Code of 1954.

This extension of the unitary apportionment concept may obviously impose unreasonable tax burdens on minority shareholders. It may create enormous legal difficulties in satisfying California's information requirements, possibly violating the laws of foreign countries. The objections of other governments to these burdens are well-founded and provide added reason for Congressional action to establish reasonable limits on State taxation of international business.

VII **Technical Comments on S. 1688**

Technical analysis of §7518, as proposed to be added to the Internal Revenue Code of 1954 by S. 1688, suggests the following comments. Proposed §7518(e)(1) refers to a corporation which "is by application of section 951 treated as having received such a dividend." Actually, §951 does not by its terms treat a dividend as having been received. The more precise language is contained in §960(a)(1) of the Code, which refers to the inclusion under §951(a) in the gross income of a domestic corporation of any amount attributable to earnings and profits of a foreign corporation. Perhaps, §7518(e) could define the amount "treated as having [been] received" in terms of §960(a)(1).

Proposed §7518(e), at the end, provides that there shall be taken into account a tax for which a credit against tax would be allowed under §901. Technically, this provision does not pick up the so-called taxes "in lieu of" income taxes because §903 does not expressly provide that it applies for purposes of §960.

At the Hearings on July 19, 1977, on the proposed U.K. convention, the point was made by the Staff of the Joint Committee on Taxation that the proposed treaty did not contain in Article 9(4) the type of detailed technical rules needed to refine the placing of restrictions on taxation by the States. It was also stated that the proposed article had not been subjected to the process of public hearings, comment, and debate needed to assist in the formulation of precise and balanced rules to deal with this complex problem.

Obviously, the bill before this Committee is somewhat broad in its scope, thereby enunciating as did the proposed treaty, the principle of international tax policy required to be followed by the States. On the other hand, the bill would simply adopt the existing, complete system in the Internal Revenue Code with respect to taxation of foreign source income. The States would be limited only in that they could tax such foreign source income only to the extent the Federal Government does so. This makes largely unnecessary any detailed rules in this bill; the appropriate provisions of the Internal Revenue Code, already painstakingly worked out by this Committee over a long period of years, would simply, in effect, be incorporated by reference. Public comment is always available in the rule-making process as provided by Congress at 5 U.S.C. §553(b), (section 4 of the Administrative Procedure Act of 1946, 60 Stat. 238).

Of course, adoption of regulations through the rule-making procedure will be necessary under any legislation resulting from action by this Committee on S. 1688. Ideally, legislative regulations, such as those adopted under such other basic statutory provisions as §482 (allocation of income and deductions among taxpayers) or §1502 (consolidated returns), authorized by Congress would be appropriate in this context.

VIII. Possible Legislative Action in California

At present there is pending in the California Senate a bill which has already passed the California Assembly. Assembly Bill 525 would change California law to provide that in determining the income subject to tax of a bank, corporation, or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation, or other entity, if such bank, corporation or other entity is -- (1) created or organized under the laws of a foreign country; (2) not owned and controlled by a U.S. corporation or residents of the United States; and (3) has more than 50 percent of its operations outside of the United States, its political subdivisions, territories, or possessions, or the Commonwealth of Puerto Rico. Corporations engaged in the energy business, the steel business, or a business concerning agricultural land in California are excepted from the protection that would be provided by this bill.

This change in approach, if adopted, would certainly be a step in the right direction by California. It does not go far enough, however, simply because it is not completely in accord with the taxation of foreign corporations by the Federal Government which has been setting, and has the right under the U.S. Constitution to establish, the international taxing policy of this Government vis-a-vis any foreign government.

Even if this bill were to be adopted in California, this Committee should nonetheless proceed with all deliberate speed to accomplish the objective to be achieved by S. 1688. There are forty-nine other States involved, in addition to California, that should be following precisely the manner of taxing foreign corporations established by the Federal Government for this Nation, as a matter of international tax policy.

IX. Conclusion

In the last analysis, as recognized in the Ways and Means Task Force report of March 8, 1977, there is little need for a State to include income of a foreign parent or its affiliates in the unitary business computation where such parent or affiliates are not doing business in the State:

> The need for applying the unitary method may not be as great when taking into account foreign source income than when taking into account income from a number of States. The number of transactions in any State linked to foreign operations is ordinarily substantially fewer than the number of transactions linked to different States. Moreover, since taxpayers are in any event required to allocate income between U.S. and foreign sources for Federal income tax purposes, the State could adopt the Federal rules for apportioning income from foreign transactions between domestic and foreign sources.*

The principle in S. 1688 is entirely consistent with international standards of taxation and with the power of the Federal Government to restrict taxation, including taxation by its political subdivisions, in the interests of fostering international trade and investment between the United States and foreign countries. The United Kingdom is the country with which the United States has had the greatest volume of trade and exchange of investment over the course of history, and that relationship should be preserved and strengthened by adoption of the principles of S. 1688.

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* Recommendations of the Task Force on Foreign Source Income, supra at p. 5.

STATEMENT
OF
ERNEST S. CHRISTIAN, JR.
ON BEHALF OF
THE COMMITTEE ON STATE TAXATION
COUNCIL OF STATE CHAMBERS OF COMMERCE
BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

IN SUPPORT OF S. 1688 AND S. 983

JUNE 24, 1980

Summary Of Statement

1. **The Committee on State Taxation strongly supports both parts of S. 1688. From the standpoint of American companies, the limitation on state taxation of foreign source dividends is at least as important as the elimination of the worldwide combination method of state taxation.**

2. **The worldwide combination method of taxation as applied by California and a few other states is inconsistent with the basic principles of state, Federal and international taxation. S. 1688 is not Federal interference with the proper interests of the states. Rather, S. 1688 would merely preclude a few states from interfering with the foreign commerce of the United States to the detriment of the citizens of all states.**

3. **A limitation on state taxation of foreign source dividends is not a radical new departure which takes away the right of a state to tax income which is properly attributable to it. Under basic principles of state taxation, states have no right to tax foreign source income at all, and generally do not. But a growing number of states are undertaking to tax foreign source dividends more heavily than they tax domestic source dividends. If states are permitted to tax foreign source dividends, their tax jurisdiction should not be greater than the Federal government's. Thus, S. 1688 permits states to tax foreign source dividends only to the extent the Federal government taxes foreign source dividends.**

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JUNE 24, 1980

Thank you Mr. Chairman. I am Ernest S. Christian, Jr., of the law firm of Patton, Boggs & Blow. I am counsel to the Committee on State Taxation of the Council of State Chambers of Commerce. I am accompanied by Mr. James F. Devitt, who is the Chairman of the Committee on State Taxation. The Committee on State Taxation, or "COST" as it is known, consists of more than 150 U. S. companies with income from multi-state and international sources. COST has for over a decade been actively involved in the analysis of all aspects of state taxes and their impacts on domestic and international business transactions. COST has contributed importantly to the study and greater understanding of the subject of state taxation of foreign source income.

The Committee on State Taxation fully supports S. 983, Senator Mathias' interstate taxation bill. It is recognized, however, that it is late in this Congress for adequate consideration of the income, sales, use, and gross receipts tax provisions of S. 983 although such consideration is needed. In the foreign source income area, which also is addressed by S. 1688, S. 983 calls for a more comprehensive restriction on state taxing authority than does S. 1688. Although we believe that the S. 983 provisions on foreign source income are correct, S. 1688 represents a reasonable compromise which should receive immediate attention.

Introductory Statement of COST'S Position In Support Of S. 1688

COST strongly supports S. 1688. It is necessary to provide Federal guidelines for state taxation of foreign source income where the taxes of some states radically depart from the accepted principles of state, Federal and international taxation, and where those aberrational state taxes interfere with the foreign relations and commerce of the United States.

Other witnesses representing foreign parent corporations with subsidiaries in the U. S. will discuss the importance of S. 1688 in protecting those foreign parent corporations from extraterritorial taxation under the worldwide combination method of state taxation. COST completely agrees with that. It should be obvious that no state should be permitted to tax the foreign source income of a foreign-owned corporation which the U. S. has absolutely no jurisdiction to tax and, quite properly, does not attempt to tax.

But COST would emphasize that S. 1688 is of even greater importance to American businesses -- U. S. companies with foreign subsidiaries which operate solely outside the U. S. Also, both parts of S. 1688 are important to American companies. There are two major problems. The first relates to the time at which foreign source income is taxed by those few states which apply the worldwide combination method of state taxation. Contrary to both state and Federal tax principles, under the worldwide combination method the foreign source income of the foreign subsidiary is taxed to the U. S. parent corporation even though the U. S. parent corporation has not received, and may never receive, any of the income. The second problem relates to the amount of foreign source income which is taxed by those 28 or so other states which tax the foreign source dividends when received by the U. S. parent corporation. Contrary to both state and Federal tax principles, when a dividend is received from a foreign subsidiary, the dividend may be taxed by any number of states even though this foreign source income has already been taxed abroad and even though states properly should not tax foreign source income at all.

These taxes are imposed on dividends despite the fact that the foreign subsidiary corporation, which earned the income, has operated solely outside the United States, has derived all its income from sources outside the U. S., and has absolutely no relationship with the state which taxes the income. From the standpoint of American companies, the part of S. 1688 which limits state taxation of foreign source dividends is just as important as the part of S. 1688 which precludes the worldwide combination method of state taxation. The two parts of S. 1688 are interdependent. It would, from an American company's point of view, be less than a satisfactory solution if the Congress merely precluded the worldwide combination method and did not also limit state taxation of foreign source dividends as provided in S. 1688.

In order to deal with the problem of the worldwide combination method, S. 1688 would first provide that a state may not tax the foreign source income of a foreign corporation prior to the time that income is taxed by the Federal government. In the case of a foreign subsidiary of a U. S. parent corporation[1], the income of the foreign subsidiary could not be taxed by the state until paid out as a dividend to the U. S. parent or until deemed paid as a dividend under the rules in subpart F of the Internal Revenue Code which prevent deferral of tax by the use of so-called tax havens. Prior to the time of a dividend, the state would have the protection of the Federal rules for allocation of income and deductions between related taxpayers and would be able to tax any income of the foreign subsidiary which was under section 482 of the Code reallocated to the U. S. parent for Federal income tax purposes.

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[1] In the case of foreign source income of a foreign parent corporation, that income would never be taxed by the state because the Federal government lacks jurisdiction to tax it.

Having first dealt with the time at which a state can tax the foreign source income of a foreign subsidiary, S. 1688 would next deal with the amount of that income which the state may tax when a dividend is received by the U. S. parent corporation. Under basic principles of state taxation, whereby income is taxed only by the state whose economy generated the income, an outright exclusion of foreign source dividends from state taxation would be justified. S. 1688 does not go that far. Under S. 1688 states would be permitted to tax, at whatever rate they choose, the same portion of foreign source dividends received from a foreign subsidiary that the Federal government effectively taxes. Because of the basic principle that the same income should not be taxed twice, both here and abroad, the Federal government allows a credit for foreign taxes and therefore effectively taxes foreign source dividends only to the extent the U. S. corporate tax rate of 46 percent exceeds the foreign tax rate. Thus, for example, if the foreign tax rate was 23 percent and the U. S. tax rate is 46 percent, the U. S. effectively taxes 50 percent of a dividend received by a U. S. corporation from a foreign affiliate. In this example, the states would be permitted to tax 50 percent of the dividend actually received plus 50 percent of the so-called Federal "gross-up" which is the amount of the foreign source income which was used to pay the foreign tax.

These two Federal guidelines for state taxation of foreign source income are of great importance as matters of national policy. State taxes are increasing far beyond the point where they can be ignored as only a minor component of the overall tax burden. More and more states are undertaking to apportion and tax foreign source dividends income which have already been taxed abroad. Many states impose discriminatorily large amounts of tax on foreign source dividends compared to their treatment of domestic dividends. Still other states have gone to the extreme of the worldwide combination method of taxation. The recent decision by the Supreme Court in Mobil Oil Corporation v. Vermont, and the obvious improbability of a sufficiently definite judicial solution, emphasizes the need for Federal statutory guidelines.

Neither of the two Federal statutory guidelines in S. 1688 is a radical new departure which takes away the right of a state to tax income attributable to that state. Instead, S. 1688 merely restrains certain aberrational state taxes which are inconsistent with the existing principles of state taxation and merely limits the right of states to tax foreign source income which states, properly, should not tax at all.

In addition, while the matter is significant, the revenue impact of S. 1688 on the states is not large. Exaggerated revenue losses asserted by some states are easily refuted. On the other hand, if the revenue loss to any state is large, that is merely evidence that the state is presently taxing large amounts of income which it properly is not entitled to tax. In this respect, the former chief of staff of the Joint Committee on Taxation observed in testimony before the Senate Foreign Relations Committee, as follows:

> "If, in fact, there is a substantial revenue loss when an arm's length standard replaces unitary apportionment, this may be an indication that unitary apportionment does, in fact, result in unjustifiable extraterritorial taxation."

Basic Outline Of Federal And State Tax Systems As They Relate To S. 1688

At the Federal level, with only a minor exception not here relevant, the foreign source income of a foreign subsidiary corporation is not taxed until such time as that income is repatriated by payment of a dividend to the U. S. parent corporation. Even then, the Federal government taxes that foreign source income only to the extent the income has not at its source been taxed at a rate at least equal to 46 percent. This avoidance of double tax is accomplished by the application of the Federal foreign tax credit. The Federal government also generally does not tax intercorporate dividends. If a dividend is received by one corporation from a domestic subsidiary either 85 percent or 100 percent of the dividend is excluded from the recipient-corporation's income for Federal tax purposes. Dividends from foreign subsidiaries are not excluded from Federal taxable income, but substantially the same result is achieved by allowing a credit for foreign taxes already paid by the foreign subsidiary.

In general, state taxes follow a similar pattern. With the exception of those states which attempt to apply the world-wide combination method, states do not attempt to tax the business profit of foreign subsidiaries which are not doing business in the U. S. and, therefore, not doing business in the state. Again, with the aberrational exceptions to which S. 1688 is directed, the entire structure of the state tax system, as developed from Supreme Court decisions interpreting the due process, equal protection and commerce clauses of the Constitution, is based on the "source" principle of taxation. Each state is entitled to tax that portion, and only that portion, of a corporation's income which the economy of that state has generated. Where domestic source income is involved, it is clear that at least one state's economy has generated the income and that at least one state is entitled to tax the income. More than likely, the income is attributable to more than one state, in which case the income is apportioned among these states according to their relative contributions. The apportionment is normally accomplished by some version of a three-factor apportionment formula as follows:

$$\frac{\text{Tangible Property, Payroll And Sales Within The State}}{\text{Total Of Above Within And Without The State}} \times \text{Total Business Income} = \text{Amount Apportioned To The State}$$

To illustrate, assume that Corporation X derives $100 of income from its business which encompasses both State A and State B (but no other); and that sixty percent (60%) of the property, payroll nd sales of that business is in State A and the balance is in tate B. The total income of $100 from the business, conducted artly within each state, will be divided between the two states s follows:

- State A will tax $60 of the $100 which is in proportion to the percentage of property, payroll and sales located in State A.
- State B will apply the same formula and tax $40 of the $100 which is in proportion to the percentage of property, payroll and sales located in State B.

Thus, while the income is apportioned in part to State A nd in part to State B, no amount of the income is apportioned o and taxed by any other state because no other state's economy enerated any part of the income. That means that where income s from foreign sources, and all of Corporation X's property, yroll and sales factors are located outside the U. S., none of rporation X's business profits are apportioned to and taxed by y state. Similarly, dividends from corporations operating lely outside the United States should not be apportioned and xed by any state because no state's economy has generated the siness profits represented by the dividend. Exclusion of reign source dividends from state taxation eliminates the cessity for states to allow a credit for foreign taxes. Such exclusion also results in parallel treatment of domestic source and foreign source dividends, since states typically do not tax intercorporate dividends received from a domestic corporation.

Given this basic pattern of Federal and state taxation, S. 1688 is directed toward correcting two aberrational departures from the basic pattern which have been undertaken by some states. The worldwide combination method departs from the basic pattern in that not only does it tax foreign source business profits which the states should not tax, it also taxes that income prior to the time it becomes subject to taxation by the United States or any state. In addition, a growing number of other states are undertaking to apportion and tax foreign source dividends received from a foreign affiliated corporation even though they do not tax dividends from domestic affiliated corporations and even though they recognize that they properly cannot tax the underlying foreign source business profits of either a foreign corporation or a foreign branch operation.

Aberration Presented By The Unitary Or Worldwide Combination Method As Applied By California And A Few Other States

The worldwide combination method used by California and a few other states[2] is a radicalized version of the basic three-factor apportionment formula. As already discussed, California is entitled to tax a corporation which is doing business in the state. In a case where that corporation is doing business in several other states, as well as in California, the income which can be taxed in California is supposed to be that portion of the corporation's total business income which is attributable to doing business in California.

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[2] Other states which apply the worldwide combination method, with varying degrees of consistency, are Alaska, Colorado, Idaho, Montana, North Dakota, and Oregon.

However, under the worldwide combination method, California, for example, combines into a single formula all the property, payroll and sales of the corporation which it has jurisdiction to tax plus all property, payroll and sales of all that corporation's worldwide foreign affiliate corporations which are not doing business in California (or even the U. S.) and which California does not have jurisdiction to tax. The worldwide income of all these corporations is then multiplied by a fraction with a California numerator and worldwide denominator. California then requires the corporation doing business in California to pay tax on the resulting percentage of the worldwide income most, if not all, of which may be the income of foreign corporations which never had any contact with California at all.

The first obvious irrational result of the worldwide combination method is that California has taxed income which it has in no way contributed to producing.

The second irrational result is that California has effectively taxed foreign corporations which it has no jurisdiction to tax. Some state tax administrators may assert that it is the in-state corporation which is being taxed, but that is patently incorrect as demonstrated by the succeeding paragraph.

The third irrational result is that California has in many cases under the worldwide combination method apportioned to itself and taxed an amount of income which exceeds the entire income from all sources of the in-state corporation over which it has tax jurisdiction and purports to be taxing. There are, in fact, examples of an in-state corporation which in the year experienced a substantial loss but which was at the same time required to pay large amounts of tax to California on income derived by affiliated foreign corporations which operated solely outside the United States and which neither the U. S. nor California had jurisdiction to tax.

The fourth irrational result is that California has imposed a discriminatorily high penalty rate of tax on the in-state corporation (if one accepts for the sake of argument that it is the in-state corporation which is being taxed). Why should it be the case that a corporation which does business in California and earns $100 must pay tax at an effective rate two or three times greater than the effective rate of tax paid by another corporation which conducts the identical business in California and also earns $100, but happens not to be related by stock ownership to some foreign corporation.

A further problem with the worldwide combination method, particularly as applied to foreign parent corporations, is the enormous accounting and administrative burden of attempting to comply with a tax imposed on a combined worldwide basis. Since these corporations are not taxable in the U. S., they have no reason to maintain books and records on a U. S. basis or on a basis which permits a three factor (property, payroll and sales) formula to be applied. Often the information about a foreign affiliate simply is not available to the in-state corporation which California purports to be taxing. In other cases, as in the case of foreign banks, for example, disclosure of certain critical information may be precluded by law.

It should also be recognized that in the case of a U. S. parent corporation which must pay tax on the earnings of its foreign subsidiary, these earnings may later be paid out as dividends and be taxed again. While California would not tax the same income again, the state of commercial domicile of the U. S. parent corporation may allocate to itself and tax the entire dividend and other nondomiciliary states may apportion and tax parts of the dividend income.

Some state tax administrators may assert that the worldwide combination method is no different from the basic three factor UDITPA formula applied domestically by other states and that because the worldwide factors are included in the denominator of the fraction, worldwide combination does not over-apportion income to the state. That assertion is, however, not correct. Worldwide combination nearly always apportions more income to the state than would be the result of applying the regular formula. That is because, as a result of lower foreign wage rates and other similar differences, the foreign factors generally are a lesser percentage of foreign income compared to U. S. factors as a percentage of U. S. income. In fact, worldwide combination has in some instances been applied unevenly and is most typically applied by states where it will yield a higher tax to the state.

These same state tax administrators may also assert that worldwide combination is a necessary substitute at the state level for section 482 of the Internal Revenue Code in order to prevent affiliated companies, through pricing adjustments and similar techniques in intercompany transactions, from artificially shifting income out of the in-state company and into the foreign affiliate. Again, this assertion does not support application of the worldwide combination method. Section 482 is a highly refined tool for preventing such shifts of income and there is no indication that section 482 is ineffective. All the section 482 information and adjustments are available to the states. Indeed, most states which do not apply worldwide combination work off the Federal income base in applying their apportionment formula. In addition, application of the worldwide combination method is not confined to those instances where there might be a real possibility of misallocation of income and deductions or to those cases where there are large amounts of intercompany transactions.

Rather than being Federal interference with legitimate state tax collections, S. 1688 is in fact designed to prevent a few states from interfering in national and international matters to the detriment of all citizens. By unilaterally adopting the worldwide combination method as applied to foreign source income, a few states have in effect:

(1) undertaken to overrule Federal policy by taxing income which the national government correctly considers to be outside its jurisdiction tax tax; and

(2) undertaken to deal with the conduct of the foreign commerce, trade and tax policies of the United States, which are the exclusive province of the Federal government and which when disrupted by the actions of one or two states can adversely affect the citizens of all other states.

In addition, these few states have undertaken to gain an advantage over other states by taxing foreign source income. Many states recognize that they properly should not tax foreign source income and do not undertake to do so. Other states do undertake to tax foreign source income, but only when that income is repatriated by payment of a dividend to the U. S. parent corporation. Much of the foreign source income which California and a few other states tax prior to the time it is repatriated may never be repatriated (either because the income may never be permitted by the foreign country to be repatriated to the U. S. by the payment of a dividend or because the income once earned by the foreign corporation may later be wiped out by losses). The other states may, therefore, never have the opportunity to tax that income.

Even from the standpoint of the few states which apply the worldwide combination method, the effect is adverse. The actual effect of the worldwide combination method is often to impose a penalty tax rate, higher than the normal rate, on companies with significant international operations. This penalty rate discourages investment in the state and adversely affects the economy of the state and of the entire country. The Governor of California and the General Assembly of that state have recognized this. In California, Assembly Bill 525, which has already been approved in the lower House of the legislature, would preclude the worldwide combination method insofar as applied to most foreign parent corporations. A.B. 525 does not, however, preclude the application of the worldwide combination method to U. S. parent corporations with foreign subsidiaries, a major defect.

For all these reasons, plus the basic inequities it creates when applied to particular taxpayers, the worldwide combination method has been thoroughly condemned by almost every group which has considered it in detail. In addition to the numerous respected U. S. business organizations and companies testifying today, the worldwide combination method has been rejected by the International Chamber of Commerce, by a study committee of the

United Nations and by a unanimous vote of all nine members of the European Economic Community.

The Report of the Ways and Means Committee's 1975 Task Force On Foreign Source Income thoroughly considered the worldwide combination method and recommended Federal legislation to preclude its application in the case of all foreign affiliates; both foreign subsidiaries of U. S. parent corporations and foreign parent corporations. S. 1688, as drafted, follows exactly the pattern of the Task Force's decision, which recommended that states be precluded from taxing the income of foreign affiliates prior to the time that income is taxable by the Federal government.

A number of years ago the Treasury Department recognized the adverse implications of the worldwide combination method and agreed to what was called Article 9(4) in the tax treaty with the United Kingdom which would have precluded states from applying the worldwide combination method to a U. K. parent corporation and its other affiliates that derive their income from sources outside the United States. While Article 9(4), because it was a treaty provision, did not deal with the reverse situation where the foreign subsidiary of a U. K. parent corporation is taxed under the worldwide combination method, implicit in Article 9(4) was a recognition that the reverse situation might be dealt with by legislation in order not to leave U. S. companies with foreign subsidiaries worse off than foreign-owned competitors.

The great importance attached to Article 9(4) by the United Kingdom and the potential difficulties for the U. S. which arose when Article 9(4) failed to gain the two-thirds vote in the Senate required for ratification, is a good example of the serious international implications arising from the unilateral actions of a few states in applying the worldwide combination method. Fortunately, the U. K. did go ahead and ratify the treaty with Article 9(4) omitted, but that ratification was delayed and the whole treaty, which contained major benefits to the U. S., was endangered. This interference in the foreign commerce of the U. S. arose directly from the unilateral action of California and a few other states. The effects of such interference are still being felt.

Aberrational Result Presented By State Taxation Of Foreign Source Dividends

S. 1688 would correct one of the glaring incongruities in state taxation: the fact that states generally tax foreign source dividends more heavily than they tax domestic source dividends despite the fact that states properly should not tax foreign source dividends at all. The limitation contained in S. 1688 with respect to foreign source dividends is fully justified in its own right, but that limitation is also a corollary to the other provision in S. 1688 which precludes states from applying the worldwide combination method to foreign source income. From the standpoint of many American companies with foreign subsidiaries, the relief granted by precluding the worldwide combination method would be more than offset if states were still permitted, in fact encouraged, to tax greater amounts of foreign source dividends and to do so without taking into account foreign payroll, property and sales factors. Much of the rationale behind precluding the worldwide combination method rests on the principle that states should not tax foreign source income. That principle is equally applicable to foreign source income in the form of a dividend from a corporation whose income is from foreign sources.

By limiting state taxation of foreign source dividends, S. 1688 does not result in preferential treatment of foreign source investment or income. Instead, S. 1688 merely limits the present discrimination against foreign source dividends.

The present burden of dividend taxation at the state level falls almost entirely on foreign source dividends because those states which tax dividends typically start with the Federal income base off Form 1120, which includes only minor portions of domestic intercorporate dividends, but includes all foreign intercorporate dividends. Under section 243, 85 percent of dividends received from a domestic corporation is excluded from income and under the consolidated return provisions dividends from domestic affiliated corporations are totally excluded from income. These exclusions avoid taxing the same income twice at the corporate level. Intercorporate dividends from foreign sources are not excluded from income (under either section 243 or the consolidated return provisions) because double taxation of those dividends is avoided by means of the foreign tax credit.

This two part rule which distinguishes between domestic and foreign source dividends works well at the Federal level, but it produces a totally illogical result when the states become involved. The states parallel the Federal rule of including foreign source dividends in the income base, but then do not follow the second part of the Federal rule (allowance of some type of credit for foreign taxes) which is the sole basis for foreign source dividends being included in the Federal income base in the first place.

While the dividends received deduction is the mechanism that the Internal Revenue Code utilizes in avoiding corporate double taxation on domestic dividends, the foreign tax credit is the device that is utilized in avoiding corporate double taxation on foreign dividends. However, since the foreign tax credit, as its name implies, is a credit rather than an exclusion, states which utilize Federal taxable income as the starting point fully include dividends from foreign corporations without allowing credit for foreign taxes paid, while they, in most cases, exclude dividends from domestic corporations, whether they are engaged in business in the United States or abroad. The result is a discrimination against foreign source dividends from foreign corporations.

The dividends received deduction under section 243 contains no requirement that the earnings of a domestic affiliate, out of which the dividend is paid, have been taxed at a 46 percent rate. The dividend may have been paid out of earnings that represent tax-exempt interest, capital gains, or accelerated depreciation and thus, the earnings of the payor corporation may not have been taxed at all or were taxed at a preferential rate. Further, a number of states do not have income taxes or impose them at relatively low rates, so in many cases there has been little or no state income tax imposed on the earnings out of which a domestic source dividend is paid.

On the other hand, the majority of dividends paid by foreign corporations were paid by corporations organized in a developed country. In 1974, gross dividends of $6.5 billion were paid by foreign corporations. The amount paid out of corporations organized in developed countries was $4.1 billion. Substantial foreign income taxes were paid on this income, both when the income was earned by the payor corporation and when the dividends were distributed. These taxes were imposed at the national level, sometimes for the benefit of local governments; in other cases taxes were imposed by the local governments for their own benefit. Thus, dividends paid by foreign corporations have borne a tax in many instances equal to, if not greater than, the tax that would have been borne on those earnings at the national and local level if the earnings had been derived in the United States. Exempting from state tax dividends paid by foreign corporations would not produce a preferential lower tax on those dividends. On the other hand, full state taxation of dividends paid by foreign corporations constitutes a discriminatory disincentive against investment outside the United States.

S. 1688 attempts to eliminate partially this discrimination by restating and applying the foreign tax credit benefit as an exclusion. The benefit of a 46 percent foreign tax credit is, for example, the same as a 100 percent exclusion, and the benefit, for example, of a 23 percent foreign tax credit is the same as a 50 percent exclusion. Therefore, the bill results in more equal taxation of dividends, regardless of the place of incorporation (domestic or foreign) of the payor.

The potential discriminatory taxation of dividends paid by a foreign corporation may be illustrated by three examples using the following basic factual pattern. Assume that a U. S. corporation conducts two business operations, one in State S and one, adjacent to S, in province P in Canada and that both operations form a unitary business. Also assume that each business derived net income of $100 for a combined taxable income of $200 and that both S and P have 10 percent corporate income tax rates. The Federal corporate rate in the United States and in Canada is 46 percent. In Canada, there is also a 15 percent withholding tax and 15 percent branch remittance tax. While the United States allows a deduction for state income taxes, Canada, on the other hand, grants a rebate of 10 percentage points. Assume S utilizes an apportionment formula in determining taxable income that is based upon property, sales and payroll.

(1) If both operations are conducted in the same corporation, the amount of income subject to state income tax will be the corporation's worldwide taxable income for Federal income tax purposes multiplied by the apportionment percentage. If one assumes that the economies in S and P are similar, then the cost of the manufacturing facilities, the payroll costs, and the sales price of the manufactured articles in S and P would be similar. Therefore, the formula would result in approximately $100 of income being apportioned to S and $100 to P. The Canadian tax burden would be $46 ($36 to the Federal government and $10 to P). There would also be an additional tax of $8.10 (15 percent of $54) upon remittance to the U. S. The U. S. tax burden would be $51.40 ($10 of tax to S plus $41.40 to the Federal government). Thus, there would be $2.70 more tax imposed upon the $100 of profits apportioned to P than on the $100 of profits apportioned to S, resulting in a total tax of $54.10 paid in Canada.

(2) If the operation in P is conducted by a wholly-owned domestic subsidiary which does no business in S, the amount of income subject to S's income tax will be the parent corporation's taxable income for Federal tax purposes. All this income would be apportioned to S because all of the parent corporation's property, sales and payroll would be attributable to S. The dividends paid by this domestic subsidiary would not be subject to S's tax, either by reason of the dividends received deduction or the elimination of dividends under the consolidated return

provisions. Thus, the tax burden to S and the overall U. S. tax burden would remain the same as in the first factual situation.

(3) If the operation in P is conducted by a wholly-owned Canadian subsidiary that does no business in S, the amount of income subject to S's income tax will be the parent corporation's taxable income for Federal tax purposes or $100. However, if the subsidiary paid a dividend of its entire earnings, a Canadian withholding tax of 15 percent of the distribution of $54, or $8.10, would be imposed, resulting in a total tax paid to Canada of $54.10. Without a dividend limitation such as contained in S.1688, S could tax this dividend. In this case, the net remittance of $45.90 could be subject to a further tax of 10 percent or $4.59, for a total tax of $58.69 on $100 of profits earned in Canada.

While in all three examples the total tax on the $100 of profits attributable to P is greater than the tax on the $100 of profits attributable to S, the largest amount of additional tax is paid in example (3). Thus, the dividends paid by the foreign corporation already bear a higher tax than other business profits. The limitation in S. 1688 on the state's right to tax these dividends would substantially eliminate any discrimination without providing any incentive for foreign investment. Under the bill, the tax burdens are substantially similar whether the Canadian operations were conducted (1) through a domestic branch in Canada, (2) through a separate domestic corporation with a branch in Canada, or (3) through a Canadian subsidiary. The result is not to provide an incentive to invest abroad, but to prevent dividends from a Canadian corporation from being discriminated against.

The mechanism by which S. 1688 would achieve this result is a reasonable and restrained approach which basically makes the state system parallel to the Federal system. The basic Federal rule is that foreign source income is first taxable by the foreign jurisdiction of its source. The basic principle of state taxation is also that income is to be taxed at its source, i.e., by the state whose economy generated the income. Foreign source income does not, however, have its source in any state and no state should tax it. But the Federal government goes farther and taxes on the basis of "citizenship" to the extent the foreign source income has not at its source borne a tax at least equal to 46 percent. States which tax foreign source dividends may argue that they, too, should be permitted to tax foreign source dividends on the basis of some type of "citizenship" concept. Obviously, state taxation of foreign source dividends cannot be justified under the source principle and, as discussed above, it is believed that Federal legislation which totally excluded foreign source dividends from state taxation would be justified.

But if states are to be permitted to exercise some type of citizenship jurisdiction in order to tax foreign source dividends, clearly that state jurisdiction should not be greater than the Federal government's, having in mind that the Federal government taxes foreign source dividends only to the extent that the income has not borne a 46 percent tax abroad.

Thus, S. 1688 would provide a system for state taxation of foreign source dividends which is essentially parallel to the Federal system: (i) states would not tax foreign source dividends fully taxed abroad which the Federal government does not tax; and (ii) states would tax income which is not fully taxed abroad, but only to the extent the Federal government effectively taxes such income. Because national rates of tax in foreign countries generally are higher than state tax rates, even though the foreign rates may be less than the Federal rate, S. 1688 does not provide that states should allow a credit for foreign taxes. Instead, S. 1688 translates the Federal foreign tax credit into an exclusion of income in order, consistent with the basic theories described above, to permit the states to tax the same portion of income which the Federal government effectively taxes. (E.g., if the foreign rate of tax is 23 percent, the Federal government effectively taxes only 50 percent of the foreign income; 46% x 50% of foreign income = 23% of 100% of foreign income).

Example

1.	Amount of dividend actually received.	$115.
2.	Grossed-up dividend to reflect 23 percent foreign tax rate.	$150.
3.	Foreign taxes paid (23% x $150)	$ 35.

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4. Grossed-up dividend x 46 percent. . . . . $ 70.
5. Item 3 divided by Item 4. . . . . 50 percent
6. Excluded portion of dividend ($150 x .50). $75.0

The result of the exclusion is to permit the states to tax, at whatever rate they apply to other income, only that portion of a foreign source dividend which the Federal government effectively taxes after taking into account the foreign tax credit.

One might ask, "Why should the states take into account taxes paid to foreign national governments and foreign local jurisdictions when states do not allow a credit or deduction for Federal taxes? After all, the Federal government would tax the income if the foreign governments did not tax it."

The Federal government does, however, allow a deduction for state taxes, so that while the nominal rate of Federal corporate tax is 46 percent, that tax is effectively reduced by 46 percent of the state tax. Consequently, the revenue from the nominal 46 percent Federal tax is in part collected by the states and in part collected by the Federal government.

By requiring states to take into account foreign taxes, instead of these taxes being taken into account only by the Federal government, S. 1688 can be viewed merely as an adjustment in the division of tax revenues with the states which results from the allowance of a deduction for state taxes against Federal taxable income. Without that deduction, one could be certain that the rate of state taxes would have to be reduced across the board, which reduction in rates would affect state tax revenues far more than would S. 1688.

Conclusion

For all these reasons, the Committee on State Taxation strongly supports S. 1688 and urges its enactment. COST again would emphasize that from the standpoint of American companies, both parts of S. 1688 are important -- the limitation on dividend taxation as well as the elimination of the worldwide combination method.

STATEMENT OF CONNIE K. BORKENHAGEN
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
JUNE 24, 1980
IN SUPPORT OF S.1688,
A BILL DEALING WITH THE EXTENT TO WHICH
A STATE, OR POLITICAL SUBDIVISION, MAY TAX
CERTAIN INCOME FROM SOURCES OUTSIDE THE UNITED STATES

ON BEHALF OF
THE AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)

This material is being submitted by Connie Borken-Hagen, 10 Barley Mow Passage, London W4 on behalf of her client the American Chamber of Commerce (United Kingdom), 75 Brook Street, London W1Y 2EB. Since the American Chamber of Commerce (UK) is a foreign organisation, Connie Borken-Hagen is registered with the Department of Justice under the provisions of 22 U.S.C 611, et seq., as an agent of such foreign principal. Copies of this material are being filed with the Department of Justice, and copies of Connie Borken-Hagen's registration statement are available for public inspection at the Department of Justice. Registration does not indicate approval of this material by the United States government.

SUMMARY

Taxes should be a neutral factor in the flow of goods and services between nations. State taxes should not interfere with or operate contrary to the trade policy of the United States, a policy which encourages free trade and competition as well as creation of capital, jobs and the economic stability of the country.

The combined reporting unitary tax is an arbitrary method used by some states to assign a portion of the income of a group of companies to the taxing state on a formula basis. At issue is the states' jurisdiction to tax corporate income and the allocation of such income among the states.

The arguments against the unitary tax are:

A. The unitary tax has irrational results because of varying world conditions.

*Faulty economic assumptions result in over-allocation of income to the states.

*It is unfair and capricious when it is applied to world commerce.

*It subjects income to substantial distortion.

B. The administrative costs and burdens of compliance are high.

C. The unitary tax has a negative international impact.

*It subjects foreign source income to substantial risk of international multiple taxation.

*It is contrary to established principles of international taxation and contrary to the federal arm's length method.

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***It creates a precedent harmful to American international interests.**

***There is the potential of retaliation by foreign nations.**

***Demands for information may violate international treaties or local laws.**

***It is an international commercial irritant.**

***It is violative of the treaties of friendship, commerce and navigation and the tax conventions of other countries.**

D. It breaches U.S. government prerogative to regulate commerce among the states and with foreign nations.

Congressional legislation is the only remedy. Treaties and litigation have failed to end the unitary tax, and state by state efforts are tedious and incomplete. Although Congress does not lack authority to make uniform taxing rules for the states, it has not done so to date. Because the United States is world leader supporting free trade in the international marketplace, Congress should immediately establish Federal standards by enacting S.1688 which would make state tax policy consistent with U.S. tax and international trade policy.

- END -

Mr. Chairman. My name is Connie Borken-Hagen. I am an American lawyer practing private international law in London, and I am retained as Special Projects Coordinator for the American Chamber of Commerce in the United Kingdom. I am grateful for the opportunity to present this statement to the Senate Finance Committee's Subcommittee on Taxation and Debt Management in support of S.1688 a bill dealing with the extent to which a state or political subdivision may tax certain income from sources outside the United States.

The American Chamber of Commerce (United Kingdom) is an independent non-profit organiration with over 1,000 British and more than 800 American members. Its primary objective is to encourage trade and investment both between and within the United States and the United Kingdom. The Special Projects Committee was formed to focus the Chamber's longstanding opposition to the unitary tax, and the very grave concern felt by the members about the dampening effect the unitary tax has had on British-American commerce. The members of the Chamber are pleased that this Subcommittee has given time to the question of the unitary tax as part of the larger question of America's role in international trade and her international commercial interdependence.

I.Tax Policy Questions

Taxes should be a neutral factor in the flow of goods and services between nations. As a matter of policy, taxation should be simple, straightforward and predictable. An efficient tax system enhances competition worldwide, helps to ensure that commerce flows freely, facilitates planning for expansion or diversification, and keeps costs down. Business and government alike benefit from such a system in terms of international trade capability and economic survival.

Taxation is based on jurisdiction. A government must have jurisdiction to tax income, and the rule accepted worldwide is that income may be taxed if it arises from and bears a reasonable relationship to activities performed within and protected by a particular governmental unit. The rule used in international tax law is that the profits of an enterprise should be those which would result if the various parts were dealing with each other at arm's length. It is the policy followed by the Federal government and is an essential element of the international trade policy of the United States.

Under the US Constitution states are permitted considerable latitude in establishing their own tax systems. The basic premise is that a state should tax only its proportion of income, which means a state must have jurisdiction to tax, and if it taxes beyond its jurisdiction such action amounts to extraterritorial taxation, prohibited by the Constitution. While states enjoy great taxing latitude within their jurisdictions, the Constitution grants the Federal government exclusive authority to regulate commerce with foreign nations (Article I, Section 8, Clause 3). States taxes should not, therefore, interfere with or operate contrary to the trade policy of the United States, a policy which encourages free trade and competition as well as creation of capital, jobs, and the economic stability of the country.

Certain state taxes differ radically from U.S. tax policy and conflict with it. They create a climate of distrust that has dampened United Kingdom enthusiasm for investment in America. At this time of U.S. concern over capital formation, economic growth and rising productivity, the U.S. should be encouraging foreign investment to enhance capital formation, create jobs and improve the U.S. balance of payments. The U.S. government must stop states' extraterritorial taxation and usurpation of Federal authority. Whether or not the United States continues to allow a lower level of government to tax international trade independent of the U.S. policy will have a considerable effect on its future foreign trade.

The Combined Reporting Unitary Tax Exceeds a State's Jurisdiction to Tax and Disrupts U.S. Foreign Relations

The combined reporting unitary tax is an arbitrary method used by some states of the United States to assign a portion of the income of a group of related companies to the taxing state on a formula basis. States have adopted a variety of differing approaches to the unitary method of taxation. A few take into account the operations of foreign affiliates of the corporation doing business in a state to the extent that the affiliate and the U.S. corporation are engaged in a single "unitary" business. In this way the unitary tax has the effect of taxing income earned abroad before it is remitted to the United States. Unlike the Federal government, states do not allow a tax credit for foreign taxes; thus states taxing foreign source income which has already been taxed abroad are penalizing a company for operating internationally.

When a foreign affiliate of a U.S. corporation earns income abroad, the foreign country in which the income was earned properly insists on taxing this income. Since the United States also taxes that income, double taxation would take all or most of the income earned abroad unless a credit were allowed. Because taxes are payments to government for services provided by governments, the country where the income is earned has the primary right to tax that income. To avoid double taxation, the home country, the USA, allows an offset or credit against the tax which would otherwise be due on income that is earned outside the United States. The effect is that U.S. firms are subject to the higher of either the U.S. or the foreign tax rate. If the foreign tax rate is higher, then it is paid and nothing is owed the U.S. Treasury. If the U.S. rate is higher, the U.S. Treasury is owed the difference between the foreign and the U.S. rate of 46%. In this way double taxation is avoided and the higher rate must be paid, thus removing taxes as an incentive for either foreign or domestic investment.

It is obvious there is a great need to provide Federal guidelines for state taxation of foreign source income, particularly where the state systems depart from accepted principles of international taxation. As a practical political matter, it is necessary to show that state tax authorities have a mutuality of interest with business; that new incentives for increased investment would outweigh possible loss of revenue; that business growth would increase the tax base.

It is also necessary to show that the leading practitioner of the unitary tax, California, has withdrawn from its position; thus a limited bill was introduced in the California Legislature which would exempt foreign earned income of most companies with foreign parents from the combined worldwide reporting unitary assessment. The purpose is twofold: first, it secures immediate relief for foreign parent companies and second, it illustrates to Congress that California's advocacy of the unitary tax has softened.

II.What Is the Unitary Tax in Theory and in Practice?

The Unitary Tax is an Aberration, a Radical Departure From Most Other States' Systems, from the Federal System, and from the Internationally Established and Recognised Arm's Length System of Taxation

The theory of the unitary tax is that various subsidiaries and affiliated corporations of a multinational really form part of a single enterprise; thus, a state determines the net income of the entire operation, then taxes a percentage of that total income based on the ratio of business activities within the state to the business activities of the entire organisation.

At issue is the state's jurisdiction to tax a corporation's income and rules for apportioning and allocating corporate income among the states in which a corporation does business.

In assessing the worldwide combination method most states that use it limit their assessment to U.S. corporations within a group. Operations of non-U.S. corporations are not taken into account. That means apportionment is only in the U.S.A, a homogenous economy. California, Oregon, and few other states include operations of foreign affiliates in the combined report where those operations are considered dependent on or are deemed to contribute to the activities of the U.S. affiliate within the taxing state. California requires that corporate groups include all foreign income of all affiliates all the time. Other states require inclusion of foreign income of foreign affiliates only occassionally.

The Alternative to the Unitary Tax System is the Arm's Length System of Taxing Corporate Profits

The Federal government taxes on the basis of citizenship and residence. That is, foreign corporations are taxed on income earned in the United States while United States corporations are taxed on worldwide income. All income received by a U.S. corporation from foreign or domestic sources is taxed to the U.S. corporation when received or deemed received. It is not taxed as the foreign subsidiary earns that income outside the United States, nor is foreign source income combined with U.S. income of the U.S. parent to tax the combined amount.

In most states non-business income is allocated to the state where the corporation has its commercial domicile, and business income is apportioned among the states in proportion to their respective economic contribution to that income.

Under the Federal method, income and costs are allocated between related companies using the criterion of what the costs and prices would be between the parties if they were independent parties dealing at arm's length (Section 482 IRC). The arm's length standard is the internationally accepted standard practiced by the Federal government and most states. Regulations prevent transfer pricing and demand a fair allocation of taxable profit.

The arm's length or separate accounting method has been the fundamental concept of U.S. tax accounting systems for 48 years. It is recognised by all countries involved in foreign trade and it is the basis for U.S. bilateral treaties. It avoids the determination of unitary and all its vaguery; it keeps record-keeping and reporting within reasonable bounds; and it eliminates the possibility of extraterritorial or double taxation.

III. The Effect of the Unitary Tax

The arguments against the unitary tax are the same whether discussing the concept on the state, Federal or international level.

A. The Unitary Tax Has Irrational Results because of Varying World Conditions.

1. Faulty economic assumptions result in over-allocation of income to the states. Some of those assumptions are:

* All members of a group operate in a homogenous market where wages, sales price, profit margins and costs of business property are the same.

* There are no differences in economic, political and social conditions worldwide.

* The same amount of income is earned from every dollar spent on wages received from sales or invested in tangible property.

* Accurate profit figures cannot be determined under the arm's length pricing of inter-company transactions.

These assumptions are faulty because:

- U.S. wages are high. Foreign wages, however, include substantial fringe benefits which are not considered by California, but which nevertheless increase costs of production.

- Property costs are particularly high in California because of pollution controls and many other factors.

- Sales or gross receipts factors ignore different profit margins because of local economic and political conditions. There is a risk of nationalisation and expropriation as well as stringent government regulations which impose tight controls on corporations doing business abroad. There are indigenisation programmes, limitations on employee dismissals, plant relocations, importation of machinery and materials costs, export and finished goods costs, currency exchange limitations and economic and political hazards.

Thus, gross profit margins must yield higher and quicker returns on investment in certain countries. California ignores the vast differences in world economic conditions and deems the same dollar of sales would yield the same dollar of profit.

2. Whereas the unitary tax might be appropriate when it is applied to a homogenous economic structure, such as the states of the United States, it becomes unfair and capricious when it is applied to world commerce which is based on different economic conditions and philosophies. In developed and developing countries, blocked, restricted or open currencies, the risk of doing business varies, and profit margins vary to reflect that risk. There can be no uniform worldwide relationship between profits, payroll, assets and revenue. Britain, particularly, is dependent on foreign trade, and British business is highly represented in developing countries.

The result, since the unitary tax is based on worldwide performance, is unfair and unequal taxation for British companies in particular, but for all companies, California unfairly taxes income which it has not contributed in producing.

3. Worldwide reporting for unitary tax purposes subjects income to substantial distortion because of significant international differences in the apportionment formula factors of sales, payroll, property values and so forth. Unless income bears the same relationship to costs throughout the world, the unitary tax will over-allocate income where payroll, property costs and sales are the highest.

4. California allocates before-tax income not after tax income. There is no tax credit for foreign taxes paid.

5. Under the worldwide combination, it is possible to tax the worldwide profits of a company when that company's subsidiary in a specific taxing state is operating at a loss. Start-up time is the most vulnerable for a company, but because a company which is successful on a worldwide scale can produce fictitious profits taxable to the California subsidiary multinationals will be reluctant to make new investments or invest in companies operating at a loss in California or any other state taxing an arbitrary proportion of worldwide earnings.

6. Radical fluctuations in currency exchange rates can result in phantom or paper earnings or losses. Since 1971 foreign currency values have floated freely and erratically against the dollar. Exchange fluctuations affect profit but phantom or "paper" earnings or losses, because they relate to increases or decreases in dollar equivalents and have no relationship to commercial realities, do not relate to real profit or loss in the California subsidiary. If other currencies are devalued against the dollar "income" can be illusory while tax is based on the exchange gains.

7. Exchange restrictions may make profits meaningless in real terms. A company may have profits in a country which restricts or bans transfer of those profits outside the country where they were earned. For instance, Ghana, Zambia, Uganda, and others prohibit repatriation of profits. For California assessment purposes, even completely blocked currencies must be included in worldwide income at the official exchange rates, yet that income is nearly useless to a company operating internationally.

8. Minority shareholders are not protected under the unitary tax. Regulations other than tax protect minority shareholders under the arm's length theory, but the unitary method assesses an allocation of profits even though shareholders may have a minority share in only one member of a group of companies. Other governments, often in the developing world, have minority shareholdings by law. If the formula is applied to all profits where there is 50% or more common ownership, then minority shareholders are called upon to pay taxes on a fictitious allocation of the profits of a group in which their interest is confined to a minority interest in one of the members.

B. The Costs and Burdens of Compliance with the Worldwide Combination Assessment Method are Absurdly High.

1. There are substantial accounting difficulties in meeting the reporting requirements. Accounting standards differ. American companies, for example, use the historical cost basis, while British companies generally use the replacement cost basis. Because of these differences there is considerable expense in providing the necessary information in the form California authorities require. A company often must recast the accounts of a whole group of companies to comply.

2. The unitary tax is complicated and costly to comply with. It requires figures, some of which, if given, might reveal confidential data about domestic operations of foreign companies. It requires complicated accounting for currency fluctuations and asks for too much information in a form which complies with the taxing state's requirements but not necessarily any other requirements. It requires inordinate and undue record keeping. Those extra costs of compliance can only be passed on to end users or consumers as increased prices.

   The administrative burden on companies is in two stages: first a company must provide considerable information to determine whether or not it is unitary; and second, if it is found to be unitary, it must complete a combined report in an accounting form suitable to California standards.

3. The high cost of compliance could even surpass the taxes involved, and does in at least one notable case, that of BAT Industries. Converting accounts to California accounting standards and rules is highly costly. Converting currencies to U.S. Dollars is costly.

C. The Unitary Tax Has an Extremely Negative International Impact.

1. The unitary tax subjects foreign source income to substantial risk of international multiple taxation. Foreign income which the worldwide combination formula purports to reach is taxed in the country where it arises. Whereas the U.S. Supreme Court can strike down state laws which result in multiple taxation among the states, or Congress can impose uniformity among the states, there is no agency, body, legislature or court with the power to ensure uniformity in apportionment on an international level. Only a series of bilateral agreements can restrict double taxation, and these are difficult to achieve. Many bilateral treaties are, in fact, being breached by the California taxing authorities now.

Finally, while the Federal government grants primary taxing jurisdiction to the country where the income arises by granting a tax credit for foreign taxes paid, and by taxing only unblocked currencies and after-tax profits, states tax before tax profits wherever they arise, and grant no tax credit.

2. The unitary tax is contrary to established principles of international taxation and contrary to the federal arm's length method, Section 482 IRC. The arm's length standard is the accepted norm, and the use of any other method is confusing to other countries and disconcerting to international relations.

3. The unitary tax creates a precedent ultimately harmful to American international interests. If the precedent is established, American companies may experience extra territorial taxation by foreign countries or their many subdivisions, or American companies may be forced to provide confidential financial information to foreign nations which may be contrary to U.S. laws, or certainly contrary to sound business practice.

One duty of government is to provide protection for its companies abroad from unreasonable foreign commercial burdens. One method of protecting a nation's commercial interest is the treaty process, a slow process of negotiating a series of agreements to impose worldwide taxing standards on the national government and its subdivisions. If the United States permits its political subdivisions to exceed international taxing terms, then other nations can equally permit extensive taxation of American company profits and devastating inquiries into those companies' commercial operations.

4. There is the potential of retaliation by foreign nations and there is U.S. precedent for such retaliation. In 1932, Congress enacted what is now Section 891 of the Internal Revenue Code as a form of retaliation against France for the extraterritorial tax France had been assessing against U.S. corporations. That law says that if a country subjects U.S. citizens or corporations resident there to extraterritorial taxation, the citizens, or corporations of the taxing country may be subject to double the U.S. tax rates ordinarily applicable. Bilateral treaties were ultimately signed but the precedent for retaliatory measures has been set by the U.S. and the U.S. is therefore vulnerable to retaliation against extraterritorial taxation by the Federal government or its subdivisions.

5. Some countries restrict transmittal of financial and operating information; thus, demands for information may violate either a treaty or local laws or both. Certain data required by the Franchise Tax Board in California might, if supplied as demanded, breach the U.K. Official Secrets Act.

6. The unitary tax constitutes an international commercial irritant of major proportions. Many foreign governments have complained, informally as well as officially, to the United States about its states' taxation standards. The unitary tax has been officially criticised by the British Government, by the Dutch Government and by all nine members of the E.E.C.

The highest levels of Government in the United Kingdom have condemned the unitary tax. In September 1979, Peter Rees at the Treasury, and Sir William Pile, then Chairman of the Board of Inland Revenue, along with several members of Parliament visited business and political leaders in Washington and California to voice the concern of the British Government over the unitary tax system.

Repeat visits by Members of Parliament were made in January 1980, and in the February 18 debate proceeding approval of the U.S/U.K. Double Tax Treaty, assurances made by House Ways and Means Committee Chairman Al Ullman to hold hearings were made part of the record in the House of Commons. Thus, the ultimate legislative authority in Britain recorded its displeasure over the unitary tax and publicly detailed its efforts to remove its extraterritorial reach.

On 25th March, when the British and American Governments exchanged instruments on the Treaty, HM Government communicated its strong disapproval of the unitary tax to the U.S. Government. The note says that while the British Government recognises the considerable achievement of the two Governments in reaching a fair and balanced agreement, it would not wish the U.S. Government to interpret ratification as approval of the unitary tax system. It reads as follows:

"It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

"Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

"Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9 (4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

"Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory....

"It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

"Her Majesty's Government has recognised, in ratifying this Convention with the approval of the United Kingdom Parliament, and its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognised the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasised however that the acceptance of the Senate reservation by the British Government in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation"(emphasis added).

A similar statement has been signed by all nine members of the European Economic Community and passed to the U.S. government by the government of Italy.

The French and Dutch Governments have objected, too, and several major international organizations have officially stated their displeasure including:

- The International Chamber of Commerce, Doc. No.180/195 or Rev., Paris, 1979 - 10-01.
- The United Nations Guidelines for Tax Treaties between Developed and Developing Countries.
- Organisation for Economic Cooperation and Development, Model Double Taxation Convention on Income and Capital.

7. The unitary tax is violative of the treaties of friendship, commerce and navigation and the double tax conventions of other countries. In practicing the unitary tax, California is in conflict with the terms of friendship, trade and shipping treaties which encourage trade and investment between America and various other countries. For instance, the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and the Netherlands requires that all political subdivisions meet general standards of reasonableness and nondiscrimination in their tax statutes.

Under the treaties of friendship in general, taxation should be based only on property which companies possess or income derived from sources within the taxing territory. In addition, business engaged in or transactions accomplished which are directly related to activities within those territories may be taxed. That is, a state can only tax the income of the entity doing business there. A state has no jurisdiction to tax beyond the activities carried on within a particular political subdivision.

The Organisation for Economic Cooperation and Development, in a resolution adopted in July 1979, specifies that the arm's length concept should be adopted by all nations of the world. (Model Double Taxation Convention on Income and Capital, and Transfer Pricing and Multinational Enterprises, Report of OECD Committee on Fiscal Affairs, July 1979). The United States is a member of the OECD, and it is a party to about 25 treaties of friendship and commerce with other nations. Each treaty specifies mutual goodwill and mutual restrictions on tax that are consistent with the arm's length standard.

It Breaches U.S. Government Prerogative To Regulate Commerce Among the States and With Foreign Nations

States have a Constitutional right to tax under the Commerce Clause and this right has been upheld in the Courts as long as states do not interfere with the Federal prerogative of establishing international trade policy. The unitary tax can be seen as state interference in national and international matters to the possible detriment of all citizens. It overrules Federal tax policy by taxing income which the Federal government considers to be outside its jurisdiction. It undertakes to conduct foreign commerce, trade and tax policies of the United States which are the exclusive province of the U.S. government. Such actions by the states can adversely affect the citizens of all other states if foreign governments choose to retaliate.

The Federal government has a duty to regulate commerce among the states. The unitary tax gives one state an advantage over its sister states by taxing foreign source income which other states may never have the opportunity to tax. States may be afraid that corporations will transfer profits outside their state. States may, however, receive reports of Federal adjustments and Federal policing under Section 482 and others to see exactly what corporate profits are. They can then use those reports to compute the tax duty. Most countries have a higher tax rate than the U.S. 46% corporate rate; therefore, at the Federal level the incentive to shift is not there, and at the state level with about 10% corporate tax rate, it is ludicrous to try to transfer profits out of state. Thus, while a fair tax can be assured without the unitary tax, the tax itself discourages capital investment and therefore reduces the number of new jobs and consequent increase in tax revenue for a state. It is said to have created a climate of uncertainty and a reluctance to invest, at least for now, for many British companies.

The United States is world leader supporting free trade in the international marketplace; therefore, Congress should establish Federal standards for a stable state tax policy which would not discourage inward investment.

IV Congressional Legislation is the only Remedy - Treaties and Litigation Have failed to End the Unitary Tax, and State by State Efforts Are Tedious and Incomplete

America's trading partners have demanded Congressional legislation and the U.S. Supreme Court has urged Congress to settle the matter of states taxing under the combined reporting unitary scheme. Even California appears ready to retreat from its position on worldwide reporting for foreign parent companies.

Attacks on the Unitary Tax through International Agreements

The unitary tax question cannot be considered without discussion of the US/UK Tax Treaty which came into effect April 24 1980. A renegotiation of the antiquated 1945 treaty became necessary when Britain changed its corporate tax structure and because the old treaty made no provision for Britain's North Sea activities, for container transport, for dual-resident companies and so forth.

The American Chamber of Commerce (UK) took an active part in the negotiations as early as 1975. The American members were affected by the new imputation system of corporate taxation in the United Kingdom. Under the British system, a corporation pays corporation tax on all profits, whether distributed or retained by the company. They do not deduct income tax from payments of dividends, but when dividends are paid, the company must make an advance payment of corporation tax (ACT) at a rate representing a percentage of the actual net dividend paid to the shareholder. Advance payments are set off against the company's corporation tax liability.

The recipient of the dividend - corporate or individual - receives a tax credit equal to the amount of the advance payment. That is, the shareholder is regarded as having received income equal to the sum of the dividend, and the credit can be used as an offset against income tax on the dividend. Of course, American shareholders, not being within the British tax net, do not have such an offset available to them.

After hard negotiations a completely revised convention was signed on behalf of both governments on December 31, 1975. Its provisions change the treatment of North Sea operations, shipping, real estate, insurance, dual-resident companies, entertainers, US residents married to UK domiciliaries and recipients of alimony. It affects the choice of business vehicle for carrying on business in the US or UK and it affects direct or portfolio investments in either country. It is a modern, comprehensive treaty and it will set a precedent for other tax treaties.

Both governments benefit from the Treaty, yet there was a delay of more than four years after it was advanced by both governments before it was approved. The stumbling block was the unitary tax.

The immediate effect of Article 9(4) was delay in ratification of the Treaty, and an exchange of notes on the highest diplomatic level. A longer term result is the delay in negotiation of the Dutch and German Treaties, currently pending. The most detrimental effects of the unilateral actions of California and others however, are to discourage inward investment in the United States, to invite retaliation and to set a precedent for use of the unitary tax by other jurisdictions around the world.

Although Congress Does Not Lack Authority to Make Uniform Taxing Rules for the States, It Has Not Done so to date Despite Repeated Efforts.

In 1977 the House Ways and Means Committee in the U.S. Congress established a Task Force on Foreign Source Income, chaired by Congressman Daniel Rostenkowski. The Task Force recommended that the states be precluded from taxing income of foreign affiliates prior to the time that income is taxable by the Federal government. It referred both to foreign parent companies and foreign subsidiaries of U.S. corporations.

S. 1688 was introduced to comply with the Task Force recommendations. It logically combines foreign and U.S. corporations, the unitary problem and the foreign source dividend problem. The legislation would limit the power of the states to tax the income of foreign affiliates of corporations through the worldwide combined reporting system. It also would limit state taxation of foreign source dividends, but permit state taxation of dividends from foreign affiliates to the extent those dividends are effectively taxed by the Federal government.

Over the past twenty years there has been concerted action to enact Federal legislation. Twice, bills have passed the House only to die in the Senate. Those bills would have imposed some uniformity and some international standards for foreign commerce.

All three branches of the Federal government have recognised the need to impose limitations on the use of the worldwide combined reporting system; the Executive branch through the Department of Treasury in its treaty negotiations and the Internal Revenue Service through its regulations; the Judicial Branch through the decisions of the Supreme Court of the United States; and the House of Representatives and the Senate of the Legislative branch through the Task Force and various bills.

The Federal government has a duty to regulate commerce among the states. The United States is world leader supporting free trade in the international marketplace; therefore Congress should establish Federal standards for a stable state tax policy consistent with U.S. tax and international trade policy. As spokesperson for nearly 2,000 British and American international companies, I urge you to enact S.1688 immediately to create a climate more condusive to British trade with and investment in the United States of America.

Thank you for giving me this opportunity to testify.

GERMAN AMERICAN CHAMBER OF COMMERCE
INCORPORATED

**Testimony before the Senate
Subcommittee on Finance and
Debt Management**

presented by

**Lothar Griessbach
Managing Director
German American Chamber of Commerce**

accompanied by

**Mr. Jack E. Gabriel, partner
Touche Ross and Company of San Francisco, California**

SUMMARY

German industry and its subsidiaries in the U.S. oppose unitary taxation on the international level for the following reasons:

1. The method internationally customary is the concept of "permanent establishment". The unitary concept is arbitrary and impractical because of unsurmountable technical obstacles.

2. Unitary taxation leads to double taxation in contradiction to the respective international conventions.

3. The international cooperation between governments on taxation and the application of sec. 482 Internal Revenue Code ascertains state revenues. Consequently there is no need for the unitary concept.

4. The possible international adoption of this method would constitute a major threat to international investment and trade.

5. Unitary taxation tends to offset losses through profits of affiliated companies overseas and, therefore, represents a major disincentive for new foreign investment.

GERMAN AMERICAN CHAMBER OF COMMERCE
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The Honorable
Senator Harry F. Byrd
Chairman
Sub-Committee on Taxation
and Debit Management
U.S. Senate

24 June 1980

Mr. Chairman:

My name is Lothar Griessbach. With me is Mr. Jack E. Gabriel, Partner in the Tax Department of Touche Ross and Company of San Francisco, California. Mr. Gabriel has extensive experience with unitary taxation in California and is available for answering questions.

I welcome this opportunity to present the views of the German American Chamber of Commerce, Inc. (GACC). The GACC is a bi-national, non-profit organization supporting U.S. business interests in West Germany as well as German interests in the U.S. It is the official German trade promotion agency.

We are closely connected with the German Federation of Trade and Industry (Deutscher Industrie- und Handelstag) which, in turn, incorporates virtually all companies in Germany because of the fact that membership in this organization is mandatory. We furthermore represent the Federal Organization of German Industries (Bundesverband der Deutschen Industrie) which is the umbrella organization of all associa-

Telex: RCA 248652

tions of manufacturers in Germany.

Both these organizations and the GACC have conducted extensive hearings in Germany and in the United States. We concluded that we should lend our support to the concept of the Bill S 1688 (A Bill to Regulate and Foster Commerce among the States by Providing a System for Taxation of Interstate Commerce). Although several subsidiaries of German companies conduct interstate business within the U.S. boundaries and are affected in their operations, we shall limit our comments to the international implications.

It is our contention that unitary apportionment methods are unnecessarily burdensome, arbitrary, lead to double taxation, are hostile to foreign investment in this country, represent a negative example for other countries, particularly those of the developing world, and thus are in conflict with declared economic policy goals of the U.S. Government. I shall elaborate on each of the above points:

1. We do not object, in principle, to taxation by States of business activities within state boundaries insofar as a fair method of assessment is applied resulting in reasonable rates of taxation. Internationally recognized methods of assessment in this regard have been developed over the years using the concept of taxation of the "permanent establishment". According to this principle, only income connected with the permanent establishment is taxed.

It is sound business practice to organize accounting procedures in accordance with these taxation principles. For reasons of true cost allocation and profit analysis, it is in the best interest of multi-national companies to account for transactions at the location where they occur.

To the contrary, the data required for the various unitary taxation formulae are not in line with the reality of business conduct. Due to different accounting methods prescribed by law, outside the areas of application of unitary taxation methods, the data required under the unitary taxation system are not readily available but have to be prepared especially for this purpose. The cost of preparing these data solely for presentation to states abroad is substantial .

To compute usable figures almost inevitably amounts to fabrication. Moreover, turnover, payroll, real estate , and other assets used in the apportionment formulae have a different impact on companies' operations in Germany; turnover, for instance, yields less income than in the United States; the payroll carries substantially higher social costs; and assets are valued and assessed for tax purposes in a different manner than in the United States. The situation is further complicated by the fluctuation of international exchange rates.

We have been informed that the California Franchise Board e.g. frequently resorts to negotiated settlements or finds itself compelled to accept financial statement income because it cannot cope with the immense mechanical difficulties.

2. Unitary apportionment methods lead to double taxation in violation of the principles and the economic purpose of the respective international treaties on the avoidance of double taxation.

A similar treatment of U.S. companies in Germany would find strong opposition by both Governments and our organization as well. It is quite inconceivable, e.g., to have "North Rhine Westphalia" or "Baden-Wuerttemberg" use worldwide acitivites of U.S.-owned companies in Germany, such as Ford, General Motors, IBM, Exxon, Esso and others, for purposes of assessing German state taxes.

3. There is agreement among governments, in particular the U.S. government and the Government of the Federal Republic of Germany, that the presently established methods of taxing multi-national companies under the concept of permanent establishment are adequate and fair, leaving aside minor adjustments currently under negotiation. Companies in both countries are subject

to extensive reporting requirements and audits by public accountants and state fiscal authorities. Cooperation between state agencies on an international level is close.

As has been pointed out frequently there is no need for unitary methods because Section 482 of the Internal Revenue Code allows the tax authorities to make adjustments to intercompany pricing.

While the "Convention between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation with respect to Taxes on Income" deals with state and local taxes in Germany, respective taxes on the U.S. side have not been dealt with. Rather than complicate the pending renegotiation of this Convention we would welcome a U.S. national solution to this problem.

4. We would like to bring to the attention of this Committee and the U.S. Government authorities that developing countries attentively observe the application of unitary taxation methods in this country. The temptation is there to adopt methods of taxation that are easy to apply and yield high revenues, such as unitary taxation. The continuation and possible international adoption of this method may, in the future, seriously affect overseas operations of U.S. companies.

5. The extra-territorial exercise of tax jurisdiction is a matter of serious concern for German companies contemplating investment in the U.S. Where applied, unitary apportionment methods represent a major disincentive to foreign investment,that is to supply the U.S. market by utilizing U.S. resources, in particular U.S. labor.

This is particularly true for initial investments which are likely to accumulate losses over a period of time. These losses under the unitary process may be set off for taxation purposes by profits of the affiliated company overseas.

Consequently, the abolishment, as proposed by the Bill, would be helpful in attracting additional foreign investment.

* * *

In conclusion, I would like to recall that the concept of the Bill is supported by the Commission of the European Communities.

Respectfully yours,

Dr. Lothar Griessbach
Managing Director
German American Chamber of
Commerce, Inc.

SUMMARY OF POSITION
OF
THE ROCHESTER TAX COUNCIL
ON S. 1688 HEARINGS
BEFORE THE SENATE FINANCE COMMITTEE

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1. The Council strongly supports the early enactment of S. 1688.

2. Apportionment of income of related corporations on a unitary basis may work reasonably well when applied to domestic income, but serious distortions arise when this concept is applied on a worldwide basis.

3. Even more unfair is the alternate state practice of including foreign source dividends in the state tax base without giving any account to foreign taxes paid in respect to such dividends, and without making any adjustment in the denominator of the apportionment formula for the property, payroll and sales of the foreign corporation which paid the dividend. This latter defect can result in over-taxation by the states of foreign dividend income by as much as tenfold.

4. The U. S. Treasury Department's position that the foreign dividend provisions of the bill may create a tax preference for foreign investment is erroneous.

5. If the Finance Committee wants to address the Treasury's concern in this area, it can easily do so by amending the bill to increase the denominator of the fraction used to determine the excluded portion of a foreign dividend to take account of the combined level of both Federal and state taxes applicable to such dividend before offset by foreign tax credits. See proposed §7518(e)(2)(b).

STATEMENT OF
G. KENNETH CHRISTRUP
DIRECTOR OF TAXES, XEROX CORPORATION
ON BEHALF OF
THE ROCHESTER TAX COUNCIL
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON S. 1688
JUNE 24, 1980

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Mr. Chairman, my name is G. Kenneth Christrup and I am Director of Taxes of Xerox Corporation. I am appearing before you to-day on behalf of the Rochester Tax Council, a voluntary organization of companies having strong affiliations with the Rochester, New York, area. The Council members are:

Bausch & Lomb, Inc.
Champion Products
Corning Glass Works
Eastman Kodak Company
The R. T. French Company
Gannett Co., Inc.
Garlock, Inc.
Gleason Works
Schlegel Corporation
Security New York State Corporation
Sybron Corporation
Xerox Corporation

Most of these companies have extensive operations and investments outside of the United States, as well as in states that apply unitary tax concepts or subject foreign dividends to state tax. Consequently, the extent to which the income of and dividends from related foreign corporations may be subject to state income tax is particularly relevant and important to them.

The Council members have long disputed the legality and equity of the California-type worldwide unitary method of taxation, both in the courts and by encouraging corrective legislation. The general principle of apportionment on a unitary basis seems to work reasonably well when applied to domestic income. However, the wide disparities in primary economic factors, such as wage and pricing levels, between those existing in the United States and in many foreign countries cause serious distortions in the apportionment formula when it is applied on a worldwide basis. This is particularly the case where profits abroad are influenced heavily by fluctuations in foreign currency exchange rates. What often results is a disproportionate amount of foreign income being allocated to the states. For example, significantly lower wages in a foreign country may permit a much better profit margin abroad than is possible in the United States. Under such circumstances, the higher wage factor in the U. S. will draw a much greater share of the net income into the state than it produces.

Even more unfair than the application of the unitary method to the payroll, property, sales and net income of a foreign subsidiary is the alternate state practice of including foreign source dividends in taxable income with no allowance whatsoever for foreign taxes paid with respect to such dividends, and without making any adjustment in the denominator of the apportionment formula for the property, payroll and sales of the foreign subsidiary which is related to this income.

For all these reasons, the Rochester Tax Council strongly supports S. 1688. This bill will substantially stop the worldwide unitary system at the water's edge by prohibiting any state from including foreign source income in its tax base unless such amount is includible in the income of the corporation for purposes of Federal income taxation. Thus, S. 1688 will transform the worldwide unitary system into a domestic unitary system which operates within the established norm of concurrent Federal and state taxation of income. S. 1688 would also provide reasonable rules for the imposition of state income tax on dividends received from related foreign corporations.

It is vitally important that S. 1688 be enacted as quickly as possible in light of the Supreme Court's two recent decisions in Mobil Oil Corporation v. Commissioner of Taxes of Vermont, No. 78-1201 (March 19, 1980), and Exxon Corporation v. Wisconsin Department of Revenue, No. 79-509 (June 10, 1980). Mobil Oil, for example, removes any uncertainty that "foreign source" dividends may be includible by the states in determining the apportionable income of a resident corporation. The Court also gave its tacit approval on constitutional grounds to state taxation of income which even the Federal Government does not tax, opening the door to allow states utilizing the worldwide unitary system to tax foreign source income which is not Subpart F income, and to tax foreign source dividends without reducing them by the amount of foreign taxes attributable to such dividends.

As we understand it, the U. S. Treasury Department is not opposed to those provisions of S. 1688 which would limit the application of the unitary business concept to affiliated domestic corporations. On the other hand, the Treasury appears to object to the proposed limit placed on the state taxation of foreign dividends, which would permit the states to tax only that portion of the dividend that is effectively subject to Federal income tax. The Treasury's position here is that the bill may create a tax preference for foreign investment because domestic investment is subject to both Federal and state income tax, whereas foreign investment will be able to avoid this second level of tax.

However, the Treasury has overlooked a fundamental principle of tax policy in reaching its conclusion that foreign investment might be unfairly benefitted by enactment of S. 1688. While it is true that the domestic operating income of multistate corporations is subject to state taxation, theoretically the burden of this tax is attributable to the benefits and privileges of engaging in business in the taxing state. Furthermore, as Treasury has noted, the multistate corporation is allowed a 100 percent dividend received deduction when this income is subsequently distributed in the form of an intercorporate dividend.

These same principles support the exclusion of foreign source dividends from the state tax base. Since the operating income is earned outside of the United States, no state can claim to have conferred a benefit upon such foreign corporation which would warrant the imposition of its state tax. The fact that the foreign jurisdiction may only subject income earned within its borders to one level of taxation should not alter this result. The availability of the 100 percent dividend received deduction is not dependent upon a showing that a particular rate of taxation has been imposed by the distributing corporation's domestic state of residence. Whether a state levies a 1 percent, 4 percent, or 10 percent rate of income tax, the multistate corporation will still be entitled to the entire dividend received deduction. Accordingly, if one wants to treat foreign investment consistently within this framework, the foreign jurisdiction should be viewed as a state which has chosen to impose a very low rate of tax. In fact, many foreign countries have political subdivisions corresponding to our states which impose significant taxes upon the operations of their resident corporations, so that concern that foreign investment receives a tax preference is unfounded.

In addition to the foregoing, it should be kept in mind that those states including foreign dividends in the base for apportionment generally fail to include the foreign property, payroll and sales factors overseas that gave rise to the income in their apportionment fractions. Unless the property, payroll, and sales values associated with the production of income by the payor corporation are included in the denominator of the apportionment formula, the inclusion of earnings attributable to that corporation in the apportionable tax base will cause the state income to be greatly overstated. For example, in his dissent from the Supreme Court's decision last March in Mobil Oil v. Vermont, Justice Stevens noted that by including Mobil's foreign source dividends in its apportionment base without including the foreign sales, payroll, and property values in the apportionment fraction, Vermont increased its share of Mobil's taxable income tenfold.

If your Committee is not persuaded by the preceding arguments, and it feels that the present version of S. 1688 might somehow create a tax preference for foreign investment, then the Committee should address Treasury's concern by amending the dividend provision of S. 1688 rather than by dropping this part of the bill altogether. For example, the denominator of the fraction used to determine the excluded portion of a dividend could easily be adjusted to reflect the fact that domestic corporations pay a state income tax. This could be accomplished by adjusting the 46 percent factor in section (e)(2)(B) to reflect the amount of state income tax paid by a domestic corporation and to take account of the Federal tax deduction attributable to such state tax. Thus, assuming a 10 percent rate of state taxation, a domestic corporation would pay an effective state and Federal tax rate of 51.4 percent, computed as follows: 10 percent state tax rate, plus 41.4 percent Federal tax rate (46 percent of 90 percent). Therefore, in this example, the denominator under section (e)(2)(B) of the Act would be 51.4 percent of the dividend.

The speedy enactment of S. 1688 will achieve two important objectives in the area of foreign relations: First, it will help assure that the United States speaks with one voice in the area of commercial relations with foreign countries. Second, it will substantially reduce the risk of international multiple taxation by requiring the states to use the same "arm's-length" separate accounting standard in taxing foreign income as is used by the Federal Government and by the international community of nations. In addition, the legislation will substantially reduce the administrative burdens of taxpayer compliance by eliminating over-lapping methods of taxing the same income, and the accompanying demands on statutory interpretation and foreign balance sheet and P&L statement translation into U. S. currency.

The problem of worldwide unitary taxation is too pressing to leave to piecemeal and uncertain resolution in our state legislatures. An early solution must be reached before other parts of the world adopt the unitary tax concept in retaliation against the imposition of the unitary tax by our states. The Council shares the concern of the Confederation of British Industries that the unitary concept may spread to developing countries, where there are no treaty networks, or to the developed countries that have taxing jurisdictions below the Federal level.

The enactment of S. 1688 will substantially reduce the risk of international multiple taxation. Presently, states may impose a tax upon an allocable portion of the entire pretax foreign source income of a foreign affiliate without providing any credit for taxes already paid to the foreign country. Furthermore, with respect to foreign source dividends, states are free to tax the entire amount of the distribution, including the amount of the foreign tax "gross-up" which is treated as a dividend received under section 78 of the Internal Revenue Code. They are not required, however, to take into account the amount of foreign taxes withheld or deemed paid with respect to such dividends. Moreover, the Mobil case suggests that they may also be free to ignore payroll, property and sales of the foreign subsidiary whose earnings provide the source of the dividends taxed by the state.

Despite the opposition of many of the state tax commissions, S. 1688, if enacted, will actually provide substantial economic benefits to the very states which presently utilize the worldwide unitary system. One of the present results of unitary taxation is that it discourages business investment and expansion in these states. For example, one of our members was highly desirous of locating a substantial new manufacturing facility in California on the basis of California's high technology environment. However, because of the additional unitary tax resulting from the increased investment in that state, financial management overruled the scientific employees and located the facility in another state. It is indeed unfortunate that the tax climate outweighed the other business advantages,that might have been provided in Calfiornia. In another example of the arbitrary and unfair nature of the unitary tax, one of the members acquired a loss company located and operating exclusively in California. The loss company's operations were totally dissimilar and substantially smaller than the highly profitable mainstream business of our member. However, as a result of the parent making loans and providing other resources to the loss company, California contended that the businesses were unitary. The immediate consequence was that the property, payroll and revenue of the smaller operation exclusively in the state resulted in the apportionment to California of 50 percent more of the profits of the mainstream business of our mulinational member. However, the short-term benefit of additional income tax revenues collected by Calfiornia must be balanced by the fact that in the future this corporation will carefully consider other locations before deciding to increase the size of its business investment in California.

The Council strongly urges the adoption of S. 1688.

Confederation of British Industry

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UNITED STATES SENATE COMMITTEE ON FINANCE

HEARING BEFORE SUB-COMMITTEE ON TAXATION

TUESDAY 24 JUNE 1980

STATEMENT ON BEHALF OF CONFEDERATION OF BRITISH INDUSTRY IN SUPPORT OF S.1688

SUMMARY OF THE STATEMENT ON BEHALF OF THE CONFEDERATION OF BRITISH INDUSTRY BEFORE THE FINANCE COMMITTEE (SUB-COMMITTEE ON TAXATION AND DEBT MANAGEMENT), U.S. SENATE IN SUPPORT OF S.1688 - TUESDAY, 24 JUNE, 1980

My name is Neil C Munro and I am the Head of the Taxation Department, Confederation of British Industry, 21 Tothill Street, London SW1. The Confederation of British Industry (CBI) directly represents some 14,000 businesses in the United Kingdom and some 100,000 businesses indirectly through affiliated trade and employer organisations. Our members are drawn from all sectors of British business.

The CBI has for a long time been very concerned about the problem of unitary taxation with combined world-wide reporting as it is applied by certain American States, in particular California, Oregon and Alaska. Our members therefore wholeheartedly support the objectives of S.1688.

The main reasons for our concern are as follows:

1. The unitary taxation basis is fundamentally unfair and contrary to internationally accepted taxation principles, as followed by all developed countries in the world and endorsed by the Organisation of Economic Co-operation and Development. The CBI wholeheartedly supports taxation on the basis of 'separate accounting' otherwise known as the 'arms-length' basis.

2. The application of unitary taxation may, in many cases, give rise to multiple taxation of the same profits.

3. The information demanded by State tax authorities, firstly, to determine whether or not a business is 'unitary' and, secondly, to assess tax on the unitary basis imposes an intolerable administrative burden on companies. In general such information is not required for any other purpose; often it is simply not available.

4. The use of the unitary taxation basis creates a highly undesirable precedent which may be followed elsewhere in the world.

The members of the CBI have made it clear that the existence of unitary taxation constitutes a very powerful disincentive to new investment in any States which apply it. Some of our members indeed have said they will not invest further in the USA while the threat exists. Unitary taxation therefore threatens the historic trading links which exist between the United Kingdom and the USA. S.1688 would remove this threat and the CBI therefore commends it to the Committee.

STATEMENT ON BEHALF OF THE CONFEDERATION OF BRITISH INDUSTRY BEFORE THE FINANCE COMMITTEE (SUB-COMMITTEE ON TAXATION AND DEBT MANAGEMENT), U.S. SENATE IN SUPPORT OF S.1688 - TUESDAY, 24 JUNE, 1980

My name is Neil C Munro and I am the Head of the Taxation Department, Confederation of British Industry (CBI). I am grateful for the opportunity to attend this hearing of the Committee, and to submit this testimony in support of S.1688 on behalf of the CBI. The CBI directly represents over 14,000 corporate organisations in Great Britain, and a further 100,000 through affiliated trade and employer organisations. Our members are drawn from all sectors of British business and they range from the largest multinational companies to the smallest concerns.

For the reasons given later in this statement, the CBI fully supports the objectives of S.1688. If enacted, this bill would have the effect that UK-owned companies which operate in the USA could be assured that their tax liability in their State of residence would be calculated by reference only to their activities in that State - in other words, by separate accounting or according to what is often described as the 'arms-length' basis of taxation. This bill is necessary because some States, notably California, Alaska and Oregon, have repudiated this principle of taxation, for reasons which in our view are mistaken, and instead seek to assess tax on a 'unitary' basis, involving a combined report of the world-wide activities and transactions of a multinational group of companies.

There are four main reasons why CBI members are worried about unitary taxation.

1. They believe the principle is unfair. CBI firmly believes in taxation on the 'arms-length' principle. A foreign company operating in any given country or territorial sub-division should be taxed there as an independent enterprise dealing at arms length with its parent company or other affiliates. This is the principle of taxation which has been followed by all developed countries in the world, and which has always been adopted in their model double taxation conventions by the Organisation for Economic Co-operation and Development (OECD), of which the USA is a leading member. This principle has been further approved by the recent report published last year of the OECD Committee on Fiscal Affairs on 'Transfer Pricing and Multinational Enterprises', an extract of which is attached as an annex to this statement.

The system of unitary taxation with combined world-wide reporting as practised by the State of California and other States does not follow these principles. Under this system, there need be no attempt to determine the profits actually earned by the local subsidiary of a multinational group of companies. Instead, a formula is used to attribute some of the total profits of the group to the operation in the State, generally by reference to the value of fixed assets, turnover and payroll in the State compared with the same values, world-wide, for the whole group.

The unitary basis works on the premise that a group of companies is a single unit and, on this basis, it is unreal to try to compute the profits of one operation of that group in isolation. The unitary system has its origins in the attempt to ensure a fairer allocation of tax revenue between various American States where a particular business - for example, a railroad company - had operations in several States. Whatever the impact of the unitary basis domestically, it has serious disadvantages in the international sphere.

We believe there can be no possible justification for extending the unitary principle to foreign-based multinational companies. The three factors - fixed assets, turnover and payroll - are likely to vary widely in different parts of the world, and it is wrong to assume that profits are produced equally from property and wages in different continents and in different economies.

The application of these factors in this way will not necessarily produce a tax liability which can be equated with the profits actually earned locally. This will apply particularly to start-up businesses: their heavy initial investment will result in low profits or even losses in the early years although, for the same reason, a computation on the unitary basis will produce what appears to be a substantial profit.

2. In many cases, it will lead to double taxation. Where a company has been unable to earn what would amount to a taxable profit computed on the arms-length basis, it may not be possible for the tax charged under the unitary basis to benefit from double taxation relief in another country. The company will therefore suffer arbitrary unrelieved taxation. A company which suffers unitary tax on some of its operations could well pay tax world-wide on a figure which is greater than its local profits, and this is clearly an inequitable result.

3. It imposes a considerable administrative burden on companies. There are two stages in the process. Firstly, a company has to provide a considerable amount of detailed information in order to determine whether or not the business is unitary. From the experience of many UK companies much of the information required seems of marginal relevance to the enquiry.

Secondly, having been ajudged unitary, the company has to deal with the problem of completing a combined report. This could be particularly onerous for foreign-based groups, who may have to rewrite the accounts of all their member companies (wherever they may be) in order to comply with the requirements of the State tax authorities. In the case of large multinational group, this could involve rewriting the accounts of up to a hundred different companies, or even more. The administrative cost of providing such information, which would not be needed in this form for any other purpose, would clearly be considerable. On some occasions, moreoever, it may not be possible to produce all the information required, in which case the company concerned may be faced with an arbitrary tax assessment, a charge to interest and heavy penalties for non-compliance.

4. It creates an undesirable precedent. CBI members, whether or not they have investment in States operating the unitary basis in this way or, indeed, any other US State, are seriously concerned that other countries and other American States may be encouraged to imitate the example of California and the few other States which seek to apply this method of taxation. If the practice of unitary taxation with combined world-wide reporting were to become widespread, the implications for international business - including US business - would be very serious.

Conclusion

For all these reasons, CBI members are very concerned about the system of unitary taxation with combined world-wide reporting as practised by certain American States. Without exception, they have indicated that the existence of unitary taxation is a very powerful disincentive to new investment in any State which applies it. Indeed, some have made it clear that they would be unwilling to contemplate any new investment in such States as long as the threat of a unitary tax liability exists; even though such investment would be desirable for commercial reasons. We understand that their view is shared by businesses in other countries. It is clear that, to the extent that this is so, this result will be very harmful both to the companies themselves and to the States themselves.

The USA is one of the oldest-established trading partners of the United Kingdom. Even now, the United Kingdom is the second largest foreign direct investor in the USA. In our view, however, this position is jeopardised by the existence of unitary tax. S.1688 would remove this threat and would therefore go far towards maintaining and reinforcing the international trading links between our two countries. The Confederation of British Industry therefore commends bill S.1688 to the Committee.

Economic Directorate
Confederation of British Industry.

16 June 1980.

The so-called " global " methods

14. **Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost plus method to arrive at an arm's length price. Nor does it follow that labour costs are the same for the same labour in different**

countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole MNE. While the widest range of such information may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. This is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total profits of the relevant MNE may not be helpful, as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.

Outline of Statement by Matthew J. Kennedy
Senior Vice President of Tax Executives Institute, Inc.
On S. 1688 and S. 983 Before
The Finance Subcommittee on
Taxation and Debt Management

Reasons for Adopting S. 1688

I. Incorporates rules similar to Federal rules of taxation to avoid double taxation by states

II. Prevents states from taxing extraterritorially, permits Federal government to speak with one voice in foreign commerce and prevents foreign retaliation against United States taxpayers

III. Eliminates costly litigation

IV. Will have little impact on taxing system and revenue of most states. Even those states who are affected may not suffer a revenue loss.

V. S. 1688 could have been broader by prohibiting the combination method entirely and by prohibiting entirely the taxation of foreign source dividends but it does not do this

VI. S. 1688 is a response to the Supreme Court's assertion that Congress should provide guidance in this area

VII. Use of Federal model avoids complexity of worldwide combination method (i.e. currency translation problems)

VIII. Approach of using Federal model (arm's length standard) better administratively and in other respects than worldwide combination method

A. Arm's length method more precise and hence more equitable

B. State revenue agents are able to use adjustments made by Federal agents

C. Arm's length standard is self enforcing if minority shareholders involved

D. Worldwide combination method difficult to administer because the "unitary" business concept is vague

E. Uniform standard at Federal and state level reduces taxpayer compliance costs

IX. **S. 1688 should be adopted now**

- A. **GAO study of effectiveness of arm's length standard should not delay adoption**
  - 1. **Problem of double taxation of foreign source income is urgent**
  - 2. **Arm's length standard used by all nations significantly involved in international trade**
  - 3. **Adoption now will prevent other states and other countries from using worldwide combination method**
- B. **S.983 is broader than S. 1688 and deals with other aspects of state taxation. S. 983 should not impede adoption of S. 1688 which addresses a narrower and more urgent problem**

Statement of Matthew J. Kennedy
Senior Vice President, Tax Executives Institute, Inc.
On S.1688 and S.983 Before
The Finance Subcommittee on
Taxation & Debt Management
June 24, 1980

For the record, I am Matthew J. Kennedy, Senior Vice President of the Tax Executives Institute, Inc. (T.E.I.)

T.E.I is an organization with approximately 3,500 individual members representing 1,100 various size corporations from small to large in the United States and Canada. Membership in T.E.I. consists of persons employed by corporations and other businesses who are charged with the administration of the tax affairs of their employers in an executive, adminsitrative or managerial capacity.

T.E.I. is concerned that a few states, most notably California, are using a method of taxation that taxes income realized from foreign sources. T.E.I. is also concerned about the likelihood that other states will follow California. The approach taken by these states is to either apply the worldwide combination method or to include dividend income from foreign sources in the income tax base. These arbitrary methods of taxation depart from accepted principles of Federal and international taxation and interfere with the foreign commerce of the United States.

T.E.I. favors enacting S.1688 into law and we take no position on S.983 at this time except we think it most important that it not impede adoption of S.1688.

1. With respect to corporate taxpayers, S.1688 generally would conform to Federal rules the reporting of foreign income for state income purposes. The tax laws of the United States through the application of the Internal Revenue Code and various tax treaties with foreign nations provide relief against the double taxation of foreign income. S.1688 would provide similar relief with regard to state income taxation. The bill incorporates the recommendations of Representative Rostenkowski's 1977 House Ways and Means Committee Task Force.

2. State taxation of foreign income causes distortion and inequities. The States which seek to tax such income are taxing the same income a second time, because the income has been subject to tax by the country which is the source of the income. Moreover, the states are taxing extraterritorially when they combine income of companies earning some or all of that income abroad. A most significant consequence is that this taxation interferes with the Federal Government's proper role under the U.S. Constitution to speak with "one voice" in the conduct of commercial relations with foreign governments. This method of taxation, also, could lead to retaliation by foreign governments and their political subdivisions against United States taxpayers.

3. S. 1688 would avoid or curtail a flood of costly litigation. Many taxpayers whose assessments have included foreign income have challenged state actions at administrative and judicial levels.

4. This bill will have little effect on the taxing systems and revenues of the great majority of states. Until recently few states have attempted to tax foreign income. The states which apply the worldwide combination method in varying degrees are California, Colorado, Idaho, Montana, North Dakota and Oregon. But as previously noted taxpayers have appealed many of these assessments before administrative boards and in litigation before the courts. Also most states do not tax dividends from foreign sources. This is accomplished either by application of statutes which exclude foreign dividends from taxable income, or by application of their laws governing allocation of dividend income.

The bill may also have little effect on revenues in those states using the worldwide combination method because it is not necessarily the case that the worldwide combination method produces more revenue than other methods like the one in S. 1688. For example, if profit margins are higher in California than abroad, then California will have less revenues under this method than under S. 1688. Furthermore, states like California do not have any accurate estimates of the amount of revenue currently being lost from the worldwide combination method. They only have estimates of additional revenue they are claiming in tax assessments and which would be lost if S. 1688 were adopted. The net effect of combining the additional revenue being sought with the revenue being lost is the only way to determine how S. 1688 will affect the few states using this method.

5. S. 1688 could have banned combinations totally but it did not do so. As a concession to the relatively few states that have adopted the combination theory, the bill would not prohibit a combination of affiliates operating in the U. S. Also, in consideration of those few states which seek to tax dividends the bill refrains from flatly forbidding the taxation of foreign income. Instead, the states will be permitted to tax that portion of a foreign source dividend which is effectively taxed by the Federal government under the Internal Revenue Code. The purpose for a partial exclusion is the avoidance of double tax which can amount to confiscatory taxation.

6. The U. S. Supreme Court has called upon Congress repeatedly, most recently in Mobil v. Vermont, to provide appropriate guidelines in this area. Furthermore, when the Senate rejected Art. 9 (4) of the U.K. Treaty to the extent it applied to state taxation one of the considerations was that this issue should be dealt with by both houses of the Congress.

7. In the case of dividends from foreign sources, the Supreme Court recognized in Mobil vs. Vermont that Vermont could tax a portion of the dividends received by Mobil from its subsidiaries operating abroad. The Institute believes that the decision was economically unsound, but in any event the Court did not decide whether double taxation existed between a foreign government and a state. It is that issue that is addressed by S. 1688.

8. We understand Assistant Secretary Gene E. Godley of the Department of the Treasury has stated in his November 2, 1979 letter to Senator Mathias that S.1688 would create a tax preference for foreign investment over domestic investment. This is not correct. Actually, the present state tax system tends to discriminate against foreign investment in a manner contrary to tax policy as established by Congress for Federal taxes, and S.1688 only equalizes the situation. In Senator Mathias' November 29, 1979 response to Mr. Godley he accurately points out that these states that do tax dividends do so by picking them up in the Federal tax base, but they do not allow the foreign tax credit which in the Federal tax system eliminates what would otherwise be double taxation. In any event, we understand that Treasury has considered altering the formula determing the amount of dividend subject to tax to avoid any perception that S.1688 would favor foreign investment.

9. The complexities of the worldwide combination scheme of taxation are demonstrated by the attached proposed California "Guideline for the Preparation of Combined Reports which include Foreign Country Operations" and comments on that guideline which are appended to it. The complexities of the Guideline show how wrong it is in the first place to stretch the unitary concept so far as to require currency translations. This is especially true in the case of groups having a substantial part of their operations outside of the United States, and doing business predominantly in other currencies, sometimes using languages other than English, and using foreign accounting concepts in computing income.

10. S.1688 prohibits a state from taxing the foreign source income of a foreign corporation if that income is not taxed by the Federal government. The requirement in Section 482 of the Internal Revenue Code that members of an affiliated group must deal at arm's length prevents one corporation from shifting income to a foreign affiliate to be taxed at lower rates. By incorporating the Code requirements, S.1688 adopts the arm's length standard to prevent a shifting of income from the United States to an affiliate abroad to avoid state taxation as well as federal taxation. Thus, S.1688 substitutes the arm's length standard in Code Section 482 for the worldwide combination method in assuring an equitable apportionment of income to the United States and abroad. The arm's length method apportions on the basis of what an unrelated party would pay or charge another unrelated party. In contrast, the worldwide combination method apportions through a formula using various factors, such as payroll, property and sales.

In testifying on the identical House version of S.1688 (H.R.5076) California indicated that the arm's length standard was more difficult to administer than the worldwide combination method.

A. At the outset, we believe that all efforts should be made to use an arm's length standard for apportioning income because it is more equitable. The arm's length standard is more precise than the worldwide combination method and by being more precise it is more equitable. Consequently, no taxpayer should be on any other basis that could produce a non-arm's length apportionment (i.e. the worldwide combination method.)

B. Contrary to California's testimony, the arm's length standard is no more difficult to, and is probably simpler, to administer than the worldwide combination for the following reasons:

(1) Adjustments under Code Section 482 made by Federal revenue agents are available to the states and are utilized by the states in making adjustments to taxable income. It would be difficult to envision a more practical solution to administering a provision than the solution of having two levels of government applying the same standard. California has an identical version of Code Section 482 in its own law (#24725).

(2) The arm's length test is self enforcing and hence much easier to enforce than worldwide combination method when minority stockholders are involved. For example, assume foreign corporation A owns 80% of domestic corporation B. The other 20% of domestic corporation B's stock is held by the public. None of corporation A's shares are held by the public. Because of the minority public interest, when B sells goods to A the price will be arm's length. If it were not, the public stockholders of B would have a legal cause of action against A for draining profits from B. The price will also be arm's length for another reason. Any tax savings that might result from shifting income by a non arm's length charge would not benefit the minority shareholders since corporation A would get the full benefit.

(3) Although the worldwide combination method may seem simpler because it uses a formula, other aspects of the method are more difficult to administer than the arm's length method. For example, before the worldwide combination method is applied to an income base, it is necessary to determine whether the income of an affiliated company like A in the preceding example should be included in the base because it is part of the same "unitary" business as corporation B in the same example. If this requirement is taken seriously by the states, and often it has not been this determination can be more difficult than determining whether a sale between the two affiliates like A and B is made at an arm's length price.

Another example of the complexity of the worldwide combination method is found in the Guideline attached. It will be noted that there are numerous pages of requirements in preparing a worldwide combination. There are many cases that have required in excess of five years to make all the adjustments called for by that Guideline.

C. On the compliance side, use of the arm's length standard at both the federal and state level will reduce compliance costs significantly. Without the uniform standard provided by S. 1688, corporate taxpayers will have to continue to prepare data and support statements, as they do now, for two entirely different systems of apportioning income between the United

States and abroad.

D. California in its statement against the bill argued that S.1688 should not be adopted until a General Accounting Office Study is completed on the efficacy of the arm's length standard of apportioning income. Therefore, California contended, Congress should not force on the states a standard that may not produce a proper apportionment of income. However, we believe that S.1688 should be adopted now because the double taxation of foreign corporate profits is a more urgent problem.

Furthermore, this problem could become even more serious if additional states decide to use the worldwide combination method. We believe that when the GAO's study is complete, Congress may then reconsider what the standard should be. Until that time it is not unreasonable to adopt a standard which is used by all the Common Market countries and the United States in apportioning income from international transactions and which after detailed study by several international organizations has been found to be the most equitable.

11. Parts of S.983 deal with taxes other than state income taxes. Consideration of those provisions should not be allowed to interfere with the adoption of S.1688. Even if Title III of S.983 which relates to state income taxes were considered separately from the rest of S.983 our conclusion would be the same. Title III deals not only with double taxation of the foreign source income of foreign corporations but double taxation of the income of domestic corporations operating only in the United States. Because S.1688 addresses a narrower, and we believe a more urgent, problem it should be adopted now.

The Institute therefore urges the subcommittee to approve S.1688 and to recommend its passage by the Senate Finance Committee.

TAX EXECUTIVES INSTITUTE
COMMENTS ON GUIDELINE FOR THE PREPARATION OF COMBINED REPORTS WHICH INCLUDE FOREIGN COUNTRY OPERATIONS

There are numerous administrative burdens that would be imposed by the Guideline. Two will be concentrated upon in these comments: namely the burdens having to do with currency translations and with book to tax adjustments.

I.

WORLDWIDE COMBINATIONS STRAIN THE UNITARY CONCEPT. THE COMPLEXITIES OF THE GUIDELINE INSOFAR AS CURRENCY TRANSLATIONS ARE CONCERNED DEMONSTRATE WHY THE UNITARY CONCEPT SHOULD BE CONFINED TO THE U.S. TO AVOID THOSE COMPLEXITIES. (See generally Part I (2 & 3) and IIB (1(b)) of the Guideline.)

The complexities of the Guideline show how wrong it is in the first place to stretch the unitary concept so far as to require such currency translations. This is especially true in the case of groups having a substantial part of their operations outside the United States, and doing business predominantly in other currencies, sometimes using languages other than English, and using foreign accounting concepts in computing income.

There are enormous problems associated with the translation of currency values from one unit to another, where "floating" values are used. If the rules in the Guideline are adhered to, books must follow one set of rules, and combined returns would have to be prepared according to another set of rules. Newest accounting rules recognize some currency gains or losses the same as the tax rules under this Guideline. But other treatments would differ. It would then be necessary to sort out which book treatments are to be followed, and which are not. Worst of all, it would be necessary to compute correlative adjustments that would follow adjustments to book treatments. The complexities would be enormous.

The rule in the Guideline requiring currency translation gains and losses to be recognized only where there is a closed transaction is an enviable goal. But it departs from generally accepted accounting principles, that is, from latest financial accounting rules. So it would require information and records, and would require the calculation of correlative adjustments, to be able to comply. All too frequently, there would not be enough information available to follow the requirements.

These complexities would drive at the very heart of and may all alone destroy the unitary concept, if applied to foreign and U. S. business together.

Take a simple situation where two affiliates, one U.S. and the second British, are subjected to a Worldwide Combination. Both make the same level of profits on the same level of investments, payroll and sales, as to year 1 when the pound is worth $2. The next year nothing changes (that is, the British affiliate earns the same number of pounds) except that the pound if worth $1.80 in year 2. The U.S. companies' income in dollars remains the same. Certainly California tax should not change, but it will, when currnecy translations are accounted for according to the Guideline.

A system of taxation built on such translations, especially where currencies are not stable as has been the case in recent years, is doomed to fail on that ground alone. A tax system that depends on these complexities, that are not provided for in the governing statute, should be adopted only as a last resort, if at all.

Not only are income accounts affected, but so also are each of the three apportionment factors.

To follow the Guideline it is necessary to convert the elements of the property factor to the currency of the parent. It is therefore necessary to convert California property to a foreign currency in the case of a foreign parent group, or to convert everywhere property to dollars, in the case of a U.S. parent group. That is an enormously complex job. It is the original cost of owned property that must be computed. To make those computations it is necessary to go back years and years into the taxpayer's books and records, and then to convert the original costs at the rates applicable each year, appropriately condidering retirements if the necessary information is available.

The payroll and receipts fractions use current conversion rates, but even then there arises the question as to which translation rate should be used among many that might apply during a year. In the first Guideline issued some time ago, taxpayers were required to use year-end conversion rates, subject to exceptions where there are substantial fluctuations in rates. In the second Guideline recently proposed, certain average rates are required to be used. Simply from the variance in rules proposed, one could get the idea that there is no precisely correct answer to an extremely important mathematical question. If that is so, one further wonders whether the system that depends upon those conversions is soundly conceived. We submit that it is not.

II.

THE NECESSITIES AND DIFFICULTIES OF MAKING BOOK TO TAX ADJUSTMENTS FOR FOREIGN AFFILIATES ALSO PROVIDE GOOD REASON FOR NOT STRETCHING THE UNITARY CONCEPT TO A WORLDWIDE BASIS. (See generally Part II of the Guideline.)

The methods used by Franchise Tax Board auditors to determine income are not consistent with the requirements in Part II of the Guideline. In many cases, this information simply is not available in the detail that would be required to conform to the Guideline, or otherwise to compute statutory taxable income on a worldwide basis.

Auditors ordinarily begin with whatever published financial reports may be obtained, and they then adjust income statements--plus or minus--for book to tax adjustments can either be estimated or extrapolated from whatever information is available. Taxpayers have had great difficulties in adjusting book income and book deductions to a tax basis. In some cases, Franchise Tax Board auditors have granted adjustments that Sacramento review staff have disallowed prior to issuance of Notices of Proposed Assessments.

In short, the difficulties of converting foreign book income to a U. S. tax basis for groups doing substantial business outside of the U. S., in other currencies, are such that the calculations of income and factors ought to be confined to the U. S.

The requirements in IIA, #1 are not being following by Franchise Tax Board auditors. In some cases, taxpayers cannot obtain profit and loss statements for foreign affiliates (sometimes hundreds of companies). It would be prohibitively costly to do so. In those cases tax is computed according to book Annual Report income, which then may or may not be further adjusted.

Often taxpayers have no way of knowing whether foreign profit and loss statements conform or do not conform to the accounting principles generally accepted in the United States. Absent U. S. regulation by such as the Securities and Exchange Commission (in case the stock is publicly traded in the U. S.), the accounting will be done in foreign currencies for foreign affiliates by foreign accountants according to foreign accounting principles, and sometimes in foreign languages. The U. S. taxpayer will have no control over the accounting, no practical way of knowing wherein the U. S. and foreign principles vary, and no practical way of knowing which and how many and what amounts of adjustments would have to be made to conform the foreign accounting to U. S. standards.

Some taxpayers would find it practically impossible and prohibitively costly to attempt to redo foreign accounting to conform to California tax law accounting. There would be some needed book to tax adjustments that would never be detected, and some that would be detected but which could not be computed without installing a U. S. book and tax reporting system for each foreign affiliate, at a prohibitive cost. Especially for large groups, this simply will never be done on a statutory basis. Any attempt to do these adjustments would be estimates, "guesstimates" and extrapolations, at best, and would be impossible to verify. Absent a full U. S. tax report system being installed, any resemblance of adjustments to correct adjustments would be accidental at best.

In summary, the proposed rules state that tax is to be computed according to California tax law, in general. To do that it would be necessary to accumulate information specifically for that purpose. To do that properly, it would be necessary to duplicate foreign book and tax reporting systems, according to California standards. This would be especially objectionable where such information is not otherwise needed for U. S. income tax purposes. California should not be able to tell a foreign corporation how to keep its books .

ATE OF CALIFORNIA
RANCHISE TAX BOARD
CRAMENTO, CALIFORNIA 95867
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December, 1979

The attached proposed "Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations" is designed to answer questions which have arisen with respect to problems caused by currency revaluations.

The proposed Guideline provides that income will be determined under what is basically the profit/loss method and provides for the calculation of the apportionment factors in the currency of the parent corporation. Adjustments to California tax accounting standards are to be made only when material.

The department asks interested parties to submit written comments to the attention of Benjamin F. Miller, Legal Division, no later than March 31, 1980. Meetings to receive comments and discuss the proposed Guideline will be scheduled throughout the State if warranted. If you wish to make an appearance, please so advise.

After reviewing all written and oral comments, the department will make appropriate revisions to the proposed Guideline and solicit further comments in the event of substantial revisions.

Martin Huff
Executive Officer

Attachment

CALIFORNIA FRANCHISE TAX BOARD

Proposed Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations

I. Introduction

When any part of a unitary business has a nexus in California, the income and apportionment factors of the entire unitary business must be included in the combined report filed with California which is utilized to determine the income properly attributable to California sources. This requirement applies equally to businesses with operations solely within the United States, United States businesses with operations in foreign countries, and businesses based in foreign countries with operations within the United States. It applies whether the business operations are carried on by a single corporation or by multiple corporations.

Prior to 1970, the relative values of the currencies of the major industrial countries were the subject of international agreement and were, for the most part, stable. Beginning in 1970, currencies were allowed to "float," which has resulted in significant changes in their relative values. These changes have given rise to questions concerning the preparation of combined reports which include operations carried on in more than one country.

In choosing a translation method for the preparation of a combined report, the department has of necessity operated under constraints imposed by unitary theory and the requirement that taxpayers, identical but for the country of origin, be treated in a similar manner. These constraints and the efficient administration of the tax law have led the department to adopt the method commonly known as the profit and loss method for the preparation of combined reports.

II. Determination of Income

A. The income of a unitary business with operations in foreign countries will be computed in the following manner:

1. A profit and loss statement will be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

2. Adjustments will be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this guideline.

3. Adjustments will be made to the profit and loss statement to conform it to the tax accounting standards required under the California Revenue and Taxation Code.

4. The profit and loss statement of each branch or corporation, whether U.S. or foreign, will be translated into the currency in which the parent company maintains its books and records in accordance with paragraph II.C.

5. Business and nonbusiness income as determined under California law will be identified and segregated.

6. Nonbusiness income will be allocated to a jurisdiction on the basis of the rules provided for in the Uniform Division of Income for Tax Purposes Act as adopted by California. (§ 25123, et seq., California Revenue and Taxation Code.)

7. Business income will be included in the combined report prepared for the unitary business and will be apportioned on the basis of the appropriate formula for the business.

8. Income from California sources will be expressed in dollars in accordance with paragraph II.C. and the taxes computed accordingly.

B. For purposes of paragraphs II.A.2. and II.A.3. the following rules shall apply:

   1. Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States—

      (a) Include but are not limited to the following:

         (i) Clear reflection of income. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(iii) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph II.E.2. of this section. For example, an adjustment will be required where inventory is written down below market value.

(iv) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(b) Currency gains or losses on closed transactions are includible, but no adjustments shall be made, nor otherwise reflected, for unrealized gains or losses resulting from the restatement or re-valuation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs.

2. The tax accounting adjustments to be made shall include, but are not limited to, the following:

(a) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the California Revenue and Taxation Code and the regulations thereunder.

(b) Inventories. Inventories shall be taken into account in accordance with the provisions of Section 24701 through 24706 of the California Revenue and Taxation Code and the regulations thereunder.

(c) Depreciation, depletion, and amortization. Depreciation, depletion, and amortization are to be computed in accordance with rules applicable to California taxpayers.

(d) Elections.

(i) Elections of all California reporting entities shall be made in accordance with applicable provisions of California law or regulations.

(ii) Elections for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of California law or regulation.

3. No adjustment shall be required under paragraphs II.B.1. and II.B.2. unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature.

C. For purposes of determining income, necessary translations will be made at the following exchange rates:

1. Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred.

2. All other items shall be translated at the simple average exchange rate for the translation period unless there is a substantial fluctuation as described in paragraph IV.F. within the period, in which case a simple average of the month-end rates or weighted average may be utilized.

III. Computation of Factors

In computing the formula factors, the following rules shall apply:

A. Property Factor

1. Fixed assets will be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

2. Rented property, capitalized at eight times its annual rental rate, will be translated at the simple average of the beginning and end of year exchange rate.

3. Inventories will be valued at original cost and will be translated at the exchange rate as of the date of acquisition.

4. For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined

as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held or reasonably expected to be held for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it will be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

5. In computing the property factor, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

B. Payroll and Receipts Factors

1. Translation is to be made at the simple average of the beginning and end of year exchange rates unless there is a substantial fluctuation, as described in paragraph IV.B.

2. Where the value of the foreign currency does fluctuate substantially, as described in paragraph IV.B., the exchange rate appropriate to that period shall be either (a) a simple average of the month-end rates, or (b) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

3. In computing the payroll and receipts factors, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

IV. Exchange Rates

A. For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Department to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation are determined by reference to the free market rate set forth in the pertinent monthly issue of International Financial Statistics or successor publications of the International Monetary Fund or such other source as the Department may designate.

B. In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

V. Application of Guideline

In computing any of the income and factors required for a combined report, due regard will be given to the effort and expense required to obtain the necessary information; and in appropriate cases the Department, in its discretion, may accept reasonable approximations. Variations from the rules set forth above, particularly with respect to foreign-based corporations, may be allowed by the Franchise Tax Board in exceptional circumstances if applied on a consistent basis and where such variations do not result in a material difference in the reporting of income over time.

Senator **Byrd**. The next panel is a panel of four, Mr. Charles W. Wheeler, U.S. Chamber of Commerce; Mr. Thomas McHugh, chairman, taxation committee, National Association of Manufacturers; Mr. William C. McCamant, vice chairman, National Association of Wholesalers-Distributors, accompanied by Mr. George W. Keeley, Esquire; and Mr. George D. Webster, general counsel, American Apparel Manufacturers Association, accompanied by G. Stewart Boswell, director, Government Relations, AAMA.

Welcome, gentlemen. You may proceed in whatever order you wish.

STATEMENT OF CHARLES W. WHEELER, U.S. CHAMBER OF COMMERCE

Mr. **Wheeler**. Mr. Chairman, my name is Charles Wheeler. I am the senior tax attorney at the Tax Policy Center for the U.S. Chamber of Commerce.

On behalf of our more than 98,600 members, I welcome this opportunity to support legislation that would provide uniform rules for State taxation of interstate commerce and that would prevent the continued use by certain States of the worldwide combined reporting system.

For a business, particularly a small business, operating in several States, the problems of tax compliance can approach the impossible. Not only do the tax laws differ from State to State, but in some cases from locality to locality.

For years, the U.S. Chamber has advocated action by the Congress to establish uniform jurisdictional standards for the imposition of taxes by the States upon interstate business, to promote uniformity in the division of income among the States, and to promote uniformity in the definition of common terms used by the States for the collection of sales and use taxes.

The adoption of S. 983 would provide much of this badly needed uniformity. The States would be assured that business was paying its full share of the tax burden, and their enforcement costs would be reduced.

Business, particularly small business, would be relieved of the threat of double taxation and of a great paperwork burden.

I would like to turn now, however, to the problem of State taxation of income from foreign subsidiaries and affiliates of corporations operating within a State. The majority of States recognize that the earnings of those foreign corporations bear no relationship to the business activities carried on within their borders. A few States, however, have subjected these foreign earnings to tax by adopting the worldwide combined reporting system.

Worldwide combined reporting, as you have heard, rests on the theory that various subsidiary and affiliated corporations of a multinational business really form part of a single enterprise. This allows the State to determine the net income of the entire operation, and then to tax a percentage of that total income based on the ratio the business activities within the State bear to the business activities of the entire organization.

While this theory may work reasonably well for apportioning domestic income among the various States, it does not operate well on a worldwide basis. Other witnesses have already provided examples of this problem.

State taxing authorities claim that the use of worldwide combined reporting is far simpler than the use of arm's-length accounting standards in trying to determine the income earned by a business enterprise within a State. While there are difficulties in making arm's-length adjustments, again, as other witnesses have pointed out, the problems of using worldwide combined reporting is even greater.

Under our constitutional system, it is the Federal Government and not the States that establishes foreign policy, and this includes the regulation of international trade. The United States has recognized that taxation can be an important factor in hindering or promoting international trade and has endeavored to make it a neutral one through the prevention of double taxation. The double taxation that often results from the use of worldwide combined reporting, however, runs directly contrary to those efforts.

The continued acceptance of worldwide combined reporting by the United States also may encourage other countries to adopt it. This represents an even greater threat to U.S. efforts to make taxes a neutral factor in international trade. Currently, the use of arm's-length accounting is the accepted international standard. It allows outstanding differences between two nations claiming the right to tax the same income of a given multinational to be settled through the use of tax treaties.

If worldwide combined reporting was adopted by either nation, it would be impossible to settle those differences through bilateral treaties, but would require agreement among all nations in which the multinational operated, an extremely unlikely event.

Presently, those States that use worldwide combined reporting do not include the dividends received from subsidiary corporations in determining the income subject to tax. If worldwide combined reporting is prohibited, it is likely that those States will attempt to include the dividends received from overseas corporations in the tax base.

These dividends should not be subject to tax at the State level since the income from the overseas subsidiary was not earned by activities within the taxing State. As a practical matter, however,

nany countries of the world impose taxes at rates lower than those
nposed by the United States. S. 1688 recognizes this fact by allow-
ng States to tax the same portion of dividends that is taxable at
he Federal level.

In conclusion, the need for the Federal Government to impose
ome degree of uniformity on the methods States use to tax inter-
tate commerce is clear, as we point out in our written testimony.
'he adoption of S. 983 merely would provide the uniformity and
nsure that a business, again, especially a small business, operating
interstate commerce could not be subject to multiple taxation
nd overly burdensome compliance costs.

The international double taxation that results from the contin-
ed use of worldwide combined reporting by certain States threat-
ns the ability of the United States to adopt a single international
rade policy. The adoption of either S. 983 or S. 1688 would prevent
ne continued use of worldwide combined reporting and ensure
nat the United States has a coherent international trade policy.

Thank you, Mr. Chairman. We have submitted a lengthier State-
nent for the record.

Senator BYRD. Thank you. It will be received.

The next witness.

TATEMENT OF THOMAS J. McHUGH, VICE PRESIDENT, TAXES, KRAFT, INC.

Mr. McHUGH. Thank you, Mr. Chairman.

My name is Thomas J. McHugh. I am vice president of taxes of
raft, Inc. I am testifying today on behalf of the National Associ-
tion of Manufacturers, in my capacity as chairman of NAM's
axation Committee.

Mr. Chairman, I will summarize our position this morning, and
ibmit a more detailed statement for the record.

The bills before us are S. 983 and S. 1688. The former is a
omprehensive approach to State taxation of income from inter-
ate commerce, while the latter is more narrowly focused on the
xation of income from foreign sources.

The NAM supports S. 983 as a reasonable step toward the solu-
on of the large number of difficult problems associated with State
les and use, income, and gross receipts taxes.

We also support S. 1688 as a compromise approach. The lack of
niformity among the States and between the States and the Fed-
ral Government presents a significant obstacle to the free flow of
mmerce and competition across State lines. The lack of compre-
ensive reform of State and local taxation has resulted in an
valanche of unnecessary paperwork for businesses of all sizes. It
as harmed the competitive posture of U.S. firms in the world
arket, and has set the stage for the fractionalization of the
nited States through interstate trade barriers and burdens.

Both S. 983 and S. 1688 would tend to lessen the trend toward
ade protectionism now growing among the States.

Recognizing the importance of sales tax revenues, S. 983 sets
rth a new plan for sales and use tax compliance. This plan has
e potential to increase revenues to the States as a result of
eater sales tax compliance rather than decrease receipts due to
e erection of jurisdictional barriers.

The problem posed by the sales and use tax collection obligation is less substantive than administrative. Sales taxes are added to the price of goods and the tax burden is borne by the purchasers. Generally, sellers are not reluctant to collect and remit a sales or use tax provided the procedure is readily understandable and administratively workable. Unfortunately, the reality of sales tax compliance and administration falls far short of this ideal.

Most prior drafts of interstate tax legislation have addressed this problem by limiting the power of the States to impose an obligation to collect the sales or use tax. S. 983 takes a much more moderate approach. Under this bill, out of State sellers would remain obligated to collect and remit sales and use taxes. However, these sellers could elect to have the purchaser certify the amount of tax applicable to the transaction. That amount could then be remitted to the State via a standard form prescribed by the U.S. Department of Commerce.

A major problem facing both States and taxpayers is the proper division of income for those taxpayers which operate in more than one jurisdiction. Historically, the method used to accomplish this division has been the separate accounting method.

In order to apportion the income of a single multistate corporation among various State tax jurisdictions, nearly all States have adopted an apportionment formula approach in lieu of the separate accounting technique. For this system of formulary apportionment to work, all taxing authorities must agree on a uniform formula. However, the States have been unable to do so.

The apportionment formula is applied not only to the income of the specific corporation operating within a State, but the formula is also applied to the income of related corporations where those related corporations are considered part of a unitary group.

S. 983 recognizes the unitary concept and sets forth a uniform definition of what entities can be combined. Again, uniformity is crucial so that States may not use combination based on whether the revenue is raised.

A major question before this subcommittee is the extent to which a State or political subdivision may tax income from sources outside the United States. For purposes of worldwide combination, the question becomes not whether the State may tax the income of a local company earned abroad, but whether the State can calculate its tax based on the currently earned and unrepatriated income of foreign corporations.

We believe the Federal method should prevail in all U.S. foreign tax matters. As a compromise proposal, we support S. 1688 as a legislative resolution of the foreign dividend issue. The legislation would prohibit worldwide combination and would impose a Federal type limit on the extent of State taxation of foreign source dividends.

The Federal Government has established a well-defined and well-understood method for taxing U.S. corporations with foreign subsidiaries and foreign corporations with U.S. subsidiaries. To the extent that States are permitted to tax income from foreign sources, they should be permitted to tax that income only at the time and to the extent that the Federal Government taxes the income.

In conclusion, the time for Federal legislation in the area of State and local taxation is long overdue. The present set of complex and often conflicting rules concerning State and local taxation of interstate commerce is a major obstacle to the proper functioning of our economy.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

The next witness?

STATEMENT OF WILLIAM C. McCAMANT, VICE CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF WHOLESALERS-DISTRIBUTORS, ACCOMPANIED BY GEORGE W. KEELEY

Mr. McCAMANT. Mr. Chairman, my name is William C. McCamant. I am vice chairman of the board of the National Association of Wholesalers-Distributors. We appreciate the opportunity to present to the subcommittee the views of our members.

We support enactment of S. 983, the Interstate Taxation bill. I would appreciate the inclusion of my written statement into the hearing record.

Senator BYRD. Without objection, it is so ordered.

Mr. McCAMANT. Our industry, the wholesale industry is composed of markets which do not recognize State lines. They cross many State lines. Senator Mathias mentioned some of the history of the legislation. I would like to mention some of the more recent history. There was a joint law passed by Congress, I believe, in 1961, that said that either the House Judiciary Committee or the Senate Finance Committee should study this area of State taxation of interstate commerce.

So, these hearings are really an endorsement of the whole Congress in a sense, and the chairman of the Finance Committee at that time indicated the Judiciary Committee should proceed with hearings, and with the study. A law was passed twice on the House side, and no action has ever been taken on this side.

As a result of that, the States did establish an Interstate Tax Commission in 1967. They have been working on it for many, many years, and no solution has ever come about. We feel that there is only one solution, and of course, the solution can only come from Congress, and that is what the courts have held.

We just feel that the Federal Government has to establish, like Mason and Dixon did years ago, a boundary line between States on business transactions. We believe that S. 983 is a reasonable start, and we support the concept of it, and that really concludes my statement, Mr. Chairman.

Mr. Keeley, who accompanies me, would like to make a few comments.

Senator BYRD. Let me ask you this. You mentioned specifically 983. What about 1688, which is a more limited bill?

Mr. McCAMANT. Now, we are concerned with wholesaler-distributors, and our people are working only in domestic commerce, and so the other bill is not of concern to us. We neither support it nor oppose it.

Senator BYRD. You need S. 983?

Mr. McCAMANT. We need S. 983.

Senator BYRD. And S. 1688 is not helpful to you?

Mr. **McCamant**. That is correct.

Senator **Byrd**. Mr. Keeley?

Mr. **Keeley**. Mr. Chairman, my name is George Keeley. I am a member of the law firm of Halfpenny, Hahn, & Roche, Chicago, Ill. I am accompanying Mr. McCamant here today, and I appreciate the opportunity to appear before you and discuss the serious burden now imposed on interstate sellers by the patchwork scheme of State and local sales and use taxes.

With the permission of the Chair, I would like to submit for inclusion in the record the prepared statements of the Automotive Service Industry Association, and also a statement prepared by Mr. William F. Harlton of the Detroit Veterinary Supply Company, and finally, a statement on behalf of the Direct Mail Marketing Association.

Senator **Byrd**. Each of those statements will be received.

[The material referred to follows:]

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STATEMENT OF:	Mr. George W. Keeley Halfpenny, Hahn & Roche
BEFORE:	Subcommittee on Taxation and Debt Management Generally Senate Finance Committee United States Senate Washington, D. C.
SUBJECT:	S. 983, The Interstate Taxation Act of 1979
DATE:	June 24, 1980

STATEMENT OF GEORGE W. KEELEY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT
GENERALLY OF THE
SENATE FINANCE COMMITTEE

My name is George W. Keeley. I am a member of the law firm of Halfpenny, Hahn & Roche, 111 West Washington Street, Chicago, Illinois. I appreciate the opportunity to appear before you today and to present a statement on behalf of the Automotive Service Industry Association ("ASIA").

ASIA is the automotive world's largest and most comprehensive organization, with its membership encompassing more than 8,500 independent automotive wholesalers, warehouse distributors, heavy-duty parts and equipment distributors, automotive electric service distributors, manufacturer representatives, manufacturers and remanufacturers of automotive replacement parts, tools, equipment, chemicals, paint, refinishing materials, supplies and accessories.

The fundamental function performed by the automotive service industry is to provide the automotive parts, supplies, tools and equipment to service and repair the Nation's 125 million registered vehicles and off-road equipment which travel over 200 billion miles annually. The companies performing this function are for the most part the small and medium-sized businesses that make up the economic backbone of our Nation's free enterprise system.

In addition our firm represents a number of small business firms who have been impacted by the serious uncertainty and confusion in the area of interstate taxation and who have contacted us about this problem.

* * * * *

My discussion today is limited to the sales and use tax, and the burden imposed on interstate sellers by the patchwork scheme of complex state and local tax laws. Forty-five states and the District of Columbia require out-of-state sellers to collect use taxes on sales made in the state, with many tests for determining liability of the out-of-state seller to collect such taxes. Local taxes, imposed by political subdivisions, must also be added to this number of tax jurisdictions which also impose varying rates and tests for collection liability.

Sixteen years ago a House Judiciary Subcommitee Report on state taxation of interstate commerce concluded that the system was in poor condition, and immediate help was needed:

> "This, then, is an assessment of the State...tax system and its effect on interstate commerce in the United States...It is the picture of a system which works badly for both business and the States. It is the picture of a system in

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*Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, State Taxation of Interstate Commerce, H.R. Rep. No. 1480, 88th Cong., 2nd Sess. 598 (1964) [hereinafter Willis Committee Report].

> which the States are reaching farther and farther to impose smaller and smaller liabilities on more and more companies. It is the picture of a system which calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliable."*

Since the Willis Committee Report was issued the situation has rapidly grown worse. In 1964, sales and use taxes were levied by approximately 2,300 state and local units. This figure has now more than doubled to 6,250 and the number is steadily growing, creating a system of taxation which chokes the free flow of commerce among the states. Also, state authorities have extended their "reach" to attempt imposition of tax liabilities on interstate sellers with only a slight occasional presence in the state.

Small Interstate Businesses Particularly Impacted

The typical interstate company is not a corporate giant with automated sales and accounting systems, a large staff of accountants and lawyers and sophisticated computer data processing equipment. In fact, the majority of firms engaged in interstate commerce have less than $1.0 million annual sales and employ fewer than twenty full-time employees.

The serious problems small businesses are facing today in this area of sales and use tax on interstate sales is well documented. The Senate Judiciary Committee chaired by Senator Mathias, held extensive hearings in four cities on S.2173, an interstate taxation bill introduced by the Senator in 1977. Dozens of businesses and other witnesses testified as to the critical need for simplicity, uniformity and fairness in interstate taxation.

The testimony of several witnesses concerned about sales and use taxation is digested below, and provides a flavor of real difficulties interstate sellers now encounter on a daily basis.

Geo. W. Park Seed Co.,
Greenwood, South Carolina
Mr. William John Park
President

Mr. Park testified on behalf of this small business, established in 1868, which sells flower and vegetable seeds to America's gardeners strictly by mail from its sole business location in Greenwood. Nevertheless, Mr. Park had received in the past few years numerous requests from other states trying to collect sales and use tax for merchandise shipped by mail or parcel service into those states.

The average sale in 1976 was $13.00 with approximately 700,000 transactions, and it would be impossible for the firm to collect and remit various state and local sales taxes around the country. Mr. Park stated: "It is unrealistic to make tax collectors for all political subdivisions out of any firm, especially small firms like Park Seed Company that has only one base of operations."

Cowell Company
Champaign, Illinois
Mr. Richard R. Tryon
President

Mr. Tryon testified on behalf of the Cowell Company, a firm established in 1927 and selling a wide variety of business forms and printed products for use by physicians in every state of the Union. The average order is $30.00 with over 350,000 orders per year filled by approximately 200 employees from their Illinois business location. Orders are shipped directly to the purchasing physician. Mr. Tryon is a past president of a national computer association and knowledgeable about computers. With respect to national sellers, he states: "I can confidently say, no business, whatever the size, can build a computer based system that can accurately cope with the problems of trying to determine the application of sales tax laws in 7,500 distinct districts to the product mix of our company."

The present aggressive efforts by states to assert jurisdiction over out-of-state sellers has caused the firm to carefully consider having its employees attend conventions out of Illinois for fear this "presence" may subject the firm to sales tax liability in the convention state. Without Federal legislation, this bad situation will become even worse.

Jackson & Perkins Company
Medford, Oregon
Mr. David Stump
President

Mr. Stump testified on behalf of Jackson & Perkins Company, the nation's largest mail order nursery selling nationally by mail and parcel service from business locations in California and New York (which alone has 60 political subdivisions with varying tax rates). His firm has invested the capital necessary to computerize the sales and use tax collection for sales made in these two states, the costs of which otherwise would be tremendously high. In a recent fiscal year, the firm collected $238,623 in California and New York state and local taxes. In order to collect, report, and pay those taxes, Mr. Stump reported that it cost over $40,000 -- almost 17 percent of the tax collected -- and this is with the assistance of an automated sales tax system.

Who pays these costs? Mr. Stump's response: "Like any other cost of doing business, these are passed on to the consumer in the form of higher prices... and higher prices are inflationary."

Paramount International Coin Corp.
Englewood, Ohio
Mr. William C. Becker
Controller

Mr. Becker testified on behalf of Paramount International Coin Corp., an interstate seller of collector's coins and newly-issued currency sold and delivered through the mails. He noted that the current system of state sales and use tax laws is encrusted with complexity and ambiguity, with rates varying from

2 to 8 percent. One state, for example, has 88 counties, 47 counties having a 4 percent rate; 40 a 4.5 percent rate; and one a 5.5 percent rate. Many sales tax assessments from other states are without legal foundation, but nevertheless are paid simply because the costs of litigation in a strange forum exceed the benefit.

Attendance by Paramount at numismatic seminars and association meetings is vital to the business' success. However, certain states are now taking the position that attendance of such meetings gives that the power to tax Paramount's sales into that state. This has discouraged such attendance. Because states have lowered their threshold tests for nexus to such an extent, the interstate businessman crosses state lines at his peril. Federal legislation is needed to alleviate this overreading.

Uncompliable State Sales and Use Tax Laws

Under what circumstances is an interstate seller liable for tax collection for sales made to another state? Unfortunately, in the majority of states neither statute nor regulation furnishes a business with a sufficiently precise answer to this fair question. As a result, interstate sellers and the attorneys advising them are often unable to determine the seller's use tax liability.

The U.S. Supreme Court ruled in the National Geographic Society v. California State Board of Equalization , 430 U.S. 551, that the "slightest presence" in a state was not sufficient for the state constitutionally to require an interstate seller to collect use tax. The Court ruled that a much more substantial presence than the expression "slightest presence" connotes is required.

Nevertheless, we still see states today attempting to enforce sales and use tax collection liability on out-of-state sellers based upon a mere temporary transition in that state by an employee or agent of the company. The net effect of inconsistent and oftentimes confusing decisions by state courts is to force an out-of-state seller, with only "minimal" contacts in a state to engage in costly litigation in an unfamiliar forum on the merits and constitutionality of a particular assessment.

Again the Willis Committee Report critically but accurately described this issue:

> "In determining tax liability, the threshold question for every business which crosses State lines is that of jurisdiction. Is the company required to file a return in the State? The jurisdictional provisions of most State tax laws do very little to help the somewhat reluctant bride across the threshold. Phrases such as "doing business" and "deriving income" are cnstrued by various administrators to produce different results where the company has anything less than a factory, administrative office, or warehouse in the State."*

The states have failed to bring about any degree of uniformity or certainty to sales and use tax law. Various State provisions impose tax collection liabilitiy on out-of-state sellers where either in-state delivery or local media advertising is done, or a combination of both activities. Where additional activities within a State are engaged in, such as pick-up of merchandise, the out-of-state seller could move closer to the nexus required for use tax collection liability.

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*Willis Committee Report, p. 594.

The law as it stands today is a series of sometimes conflicting U.S. Supreme Court decisions relating to specific matters of interstate taxation and a series of laws, intra-state in nature, developed by the various States. The inconsistency and complexity of these various laws places the interstate seller in a serious quandry. Doubts as to coverage by various States and local governments as to the same transaction exist without any definitive answers and the interstate seller must operate at his own peril.

State and local taxing authorities, eager to obtain greater and greater revenue, are aggressively pursuing interstate sellers in the sales and use tax area. These out-of-state sellers are safe targets for these collection efforts: They are not for the most part sophisticated businesses able to bear the cost of litigating an assessment in a distant state court; nor are they as non-residents of the taxing state able to vote or "be heard" politically on the taxation issue.

This is clearly evident in the experience of Mr. William F. Harlton, Jr. of Detroit Veterinary Supply Co. with the State of New York. His company had no place of business or sales persons traveling in the State, but did make one mail order sale to a New York veterinarian. As a result of this sale, the State taxing authority arbitrarily issued a sales tax assessment in the incredible sum of $1,223,460.00. In this case a small businessman was harassed for over four months with this outrageous, unfounded tax assessment before it was finally withdrawn. Mr. Harlton's entire statement will be submitted for inclusion in the record.

Another example is provided in the recent case of In The Matter of Aldens, Inc. v. Tully, et al, decided by the New York Court of Appeals on March 25, 1980, dealing with an interstate seller's liability for local use taxes. Aldens, through a separate wholly-owned subsidiary, maintained four telephone offices in New York City and three counties used to receive orders and secondarily to solicit orders by telephone. All orders were forwarded to Illinois for acceptance and merchandise was shipped to the New York customer. Aldens dutifully collected and remitted State use tax on New York sales, and also local use tax on sales into the four political subdivisions where it maintained offices.

Aldens did not, however, collect local use tax for sales made into the other 74 political subdivisions where no offices were located, their only contact with these localities being by mail or common carrier.* The Sales Tax Bureau of The State Department of Taxation and Finance assessed Aldens $93,902.06 for local use taxes due on sales to customers in these other localities.

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*In addition to the New York State use tax of 4 percent, New York City imposes a 4 percent use tax and 46 counties and 32 cities impose a use tax with rates varying from 1 percent to 3 percent.

The Court of Appeals ruled in favor of the taxing authorities, holding that the Constitution did not prevent imposition of a local use tax on an interstate seller having no connection or "nexus" with the local political subdivision, other than contacts by mail or common carrier. The opinion distinguished away prior decisions of the U.S. Supreme Court -- which require a nexus between the taxpayer and the taxing authority -- because they involved state, not local, use taxes.

This illustrates the serious need for definite jurisdictional standards to limit the power of a State or a political subdivision to require an out-of-state seller to collect a sales or use tax on sales in that State. To prevent future abuses, the power to tax should be limited to sellers with a "business location" in the taxing State or in the political subdivision, or to sellers who make household deliveries in the taxing State or political subdivision other than by U.S. Mail or common carrier.

A seller has a business location in the State when he owns or leases real property within the State, or has one or more employees located in the State, or regularly maintains a stock of tangible personal property in that State for sale in the ordinary course of business.

These are the same jurisdictional standards advanced in prior legislation, including the two bills passed previously by the House of Representatives.* These standards protect the out-of-state business selling in interstate commerce but also protect the interest of the States and political subdivisions in collecting the taxes to which they are entitled.

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* H.R. 2158, introduced in the 90th Congress, passed The House on a vote of 284 to 189. Then in the 91st Congress H.R. 7906 was again passed by The House by a four to one margin.

Conclusion

A national uniform code in interstate taxation is the only viable avenue to reach the certainty and fairness required by interstate businesses in determining their tax collection liability. Congress has given the States nearly two decades to work out a solution among themselves to problems of sales and use taxation on interstate sales. The Multistate Tax Commission, organized in 1967 to make Federal legislation in this area unnecessary, has failed miserably. We believe it is impossible to obtain a compact among the 50 states, or even to obtain some uniformity without Federal legislation.

The time has come when the burden on interstate commerce and interstate businesses has reached such proportions that Congressional action is all that will prevent a severe restriction on that commerce. Unless some certainty is restored, the economic implications for the economy of the entire nation may be unfortunate. We strongly recommend timely action on this important subject.

June 24, 1980

STATEMENT OF Mr. William F. Harlton, Jr.
Vice President
Detroit Veterinary Supply Co.

BEFORE: Subcommittee on Taxation and Debt Management Generally
Senate Finance Committee
United States Senate
Washington, D. C.

SUBJECT: S. 983, The Interstate Taxation Act of 1979

DATE: June 24, 1980

STATEMENT BY WILLIAM F. HARLTON, JR.
ON BEHALF OF THE DETROIT VETERINARY SUPPLY CO.
BEFORE THE SENATE AND FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT GENERALLY

My name is William F. Harlton, Jr., Vice President of the Detroit Veterinary Supply Co., having our sole business location in Detroit, Michigan. I appreciate the opportunity to appear before the Subcommittee today and relate some of the problems our business has experienced in the sales and use tax area on interstate sales of our products.

The Detroit Veterinary Supply Co. was founded by my father's uncle in 1904 and has been in business continually since then. I have been in the business since 1937 and owned it from 1954 until January 1, 1978, when I sold it to my son. I still am active in the business and am a Vice President of the company.

Our business sold veterinary drugs and supplies to veterinarians all over the United States, including Hawaii, Alaska and Puerto Rico. In fact, we have made sales to all parts of the world. Now we are concentrating primarily in Michigan and Ohio, although we still receive a few orders from all over the country.

Ours is a small company. Our volume of sales is approximately $800,000 a year and the average sale is somewhere between

$50 - $100. Some years ago, 40 percent of our sales were made to customers outside the State of Michigan. Now, out-of-state sales are down to around 15 to 20 percent. We provide employment to 14 people who assist us in servicing our customers. Our only business location is in the State of Michigan.

At one time, we sent out catalogs to veterinarians regularly; however, since 1973 prices have been very unstable and we, as wholesalers of veterinary drugs, have received numerous price increases from our manufacturers. These constant changes made it difficult to keep catalogs current and of course the cost of printing and the cost of mailing have also skyrocketed.

Every once-in-a-while, we get letters from local and state taxing authorities saying we owe taxes. I guess they audited the local veterinarians and found some of our products or bills, so they write asking why we are not paying sales and use taxes. Normally, we ignore the letters and they forget it because sales are small.

However, several years ago the New York State Department of Taxation and Finance accused us of doing business in the State of New York and demanded we take out a sales tax license. As far as we can determine, they made this decision on the basis of one sale in the State of New York. I might add that we have no place of business in the State of New York, nor do we have sales persons traveling in New York soliciting sales in that state.

When we did not respond, the Department of Taxation and Finance notified us that we owed the State of New York back taxes to the incredible sum of $1,223,460. The exchange of correspondence between our company, Detroit Veterinary Supply Co., and the Department of Taxation and Finance of the State of New York is attached to this statement.

You will note they arbitrarily assessed $17,000 seven times for periods ending in 1973 and 1974. Further, they assessed us $20,000 for nine more periods which ended in 1974, 1975 and 1976, for a total of $708,000. To this they added $515,460 as penalties and interest for a total of $1,223,460.

I am convinced that this type of correspondence with our company was a form of blackmail to scare us into taking out a New York sales tax license. You will note in our letter of May 19 to the State of New York we stated "Currently we do not anticipate any future sales into New York. Under the circumstances, we believe a sales tax license will be unnecessary." Your attention is called to their response dated June 14 in which they stated they were withdrawing the demand that our firm register with the state and cancelling the assessment. In other words, the State taxing authority has been successful in halting interstate commerce.

This a frightful confrontation. As a small businessman, I was subjected to an unfounded, arbitrary sales tax assessment by the State of New York for $1.2 million for over four months, not knowing whether this assessment would wipe out the business my family has built for over 70 years. It is my belief that there should not be walls built around the states, and that business should be free to engage in interstate commerce without such threats. Perhaps this Subcommittee may wish to inquire of the Department of Taxation and Finance of the State of New York and, any other States, why they adopt such tactics.

The laws are constantly changing. At first, it would appear it would be a simple thing to collect sales taxes from around the country. We found it increasingly complicated for there were so many changes and more and more different exemptions. Even if we had copies of all the laws in the United States, we wouldn't be able to know what would be proper to collect or not to collect from our customers, and customers can be very touchy about the amount of tax.

An example is Ohio, where there are two levels -- some counties tax 4% and some tax 4 1/2% and the list constantly changes.

In Indiana, we have a different problem. The law says: "The following is non-taxable in Indiana:

> All sales to veterinarians of drugs of a prescription type are exempt when such items are to be directly consumed in professional use."

This would seem to be simple, but it is very, very difficult to apply and determine. You have to take your customer's word. This is the type of thing you run into. An out-of-state business can't possibly know all the exemptions and local interpretations.

Filling out forms for Michigan takes a lot of man hours. If we had to do this same job for the few dollars of sales all over the country, it would take untold hours of work and it would cost so much we would have to turn down orders to avoid the bookkeeping costs. Even if we had a computer, the computer time would be costly. And for example, if you are late filing and paying in Michigan, there is a 25% penalty.

We note that the bill under consideration would address many of the severe sales and use tax problem areas which now confront daily the interstate seller. We believe Congressional action to clarify this is long overdue. It is not in the best interests of the general public, the business community or even the States to interfere with, restrain or restrict commerce among the States. Only the Congress can establish uniform rules so that the States will know the limit of their taxing jurisdiction and we businessmen will be able to comply with the law, as we all wish to do.

Again, I appreciate the opportunity to express these views. Thank you.

June 24, 1980

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
STATE CAMPUS
ALBANY, N.Y. 12227

STATE TAX COMMISSION

SALES TAX BUREAU
FRANCIS X. MALONEY
DIRECTOR

ADDRESS YOUR REPLY TO
Mr. R. Hawkes
Audit & Review Uni
Tel. (518) 457-244

DEC 3 1976

Detroit Veterinary Supply
1798 Wabash
Detroit, Michigan

Gentlemen:

It has come to our attention that your firm is selling taxable items (veterinary supplies) in the State of New York without collecting applicable sales taxes.

The Tax Law regarding sales to veterinarians was changed June 1, 1967. Now, any taxable items you sell to veterinarians are to be considered retail sales, for tax purposes, and you must collect the tax. In other words, everything you sell to a veterinarian in New York State is taxable.

Accordingly, we request that you complete the enclosed registration forms, and return them, within ten (10) days, in the envelope provided.

Very truly yours,

Robert S. Rightmyer

Robert S. Rightmyer
Chief, Audit & Review Unit

RH:do
Enc: Registration Kit

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE

STATE TAX COMMISSION

STATE CAMPUS
ALBANY, N.Y. 12227

SALES TA
FRANCIS K.
ADDRESS YOU
Mr. R. Hawken
Audit and Review
Tel. (518) 457-24

JAN 14 1977

Detroit Veterinary Supply
1798 Wabash
Detroit, Michigan

Gentlemen:

On December 3, 1976 we requested that you register with the New York State Sales Tax Bureau. As of this date, we have not received your reply.

Failure to reply within thirty days will result in the issuance of an estimated assessment for tax, penalty and interest in accordance with Section 1138 of Article 28, the Sales and Use Tax Law.

Your reply should be addressed to the Audit and Review Unit of the Sales Tax Bureau, State Campus, Albany, NY 12227.

Very truly yours,

Robert S. Rightmyer

Robert S. Rightmyer
Chief, Audit and Review Unit

RH:aa

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
SALES TAX BUREAU
STATE CAMPUS
Albany, New York 12226

NOTICE OF DETERMINATION AND DEMAND FOR PAYMENT OF SALES AND USE TAXES DUE

Notice Number	90,725,618
Date of Notice	3/7/77
Identification Number	

Detroit Veterinary Supply
1798 Wabash
Detroit, Michigan

Make payment promptly at your State District Tax Office. TCB-Albany-Z

Make remittance payable to New York State Sales Tax Bureau.

Please show notice number on face of check or money order.

Return one copy of this notice with your payment.

NOTE: This determination shall be final unless on application for a hearing is filed with the State Tax Commission within 90 days from the date of this notice or unless the Tax Commission shall redetermine the tax.

tax stated below is for the periods ended: 8/31/65 -11/30/76

planation:

BALANCE BROUGHT FORWARD FROM ATTACHMENT

PERIOD ENDED	TAX	P & I	TOTAL
2/28/73	$17,000.00	$ 8,840.00	$25,840.00
5/31/73	17,000.00	8,330.00	25,330.00
8/31/73	17,000.00	7,820.00	24,820.00
11/30/73	17,000.00	10,880.00	27,880.00
2/28/74	17,000.00	10,370.00	27,370.00
5/31/74	17,000.00	9,860.00	26,860.00
8/31/74	17,000.00	9,350.00	26,350.00
11/30/74	20,000.00	10,400.00	30,400.00
2/28/75	20,000.00	9,600.00	29,800.00
5/31/75	20,000.00	9,200.00	29,200.00
8/31/75	20,000.00	8,000.00	28,000.00
11/30/75	20,000.00	6,800.00	26,800.00
2/29/76	20,000.00	5,600.00	25,600.00
5/31/76	20,000.00	4,400.00	24,400.00
8/31/76	20,000.00	3,200.00	23,200.00
11/30/76	20,000.00	2,000.00	22,000.00
	$708,000.00	$515,460.00	$1,223,460.00

	Amount Now Due
TOTAL TAX, PENALTY AND INTEREST DUE	$1,223,460.00

Taxing Jurisdiction: (0002) $1,223,460.00

Note: In order to expedite the crediting of your payment, please use the enclosed envelope to forward your reply to the Tax Compliance Bureau, State Campus, Albany, New York 12227.

[illegible]

The amount shown above is a balance due on your account. Prompt payment will avoid additional interest.

ATTACHMENT TO ST-570 OR ST-571

Notice Number
90,725,618

Identification Number

TCB-Albany-Z

3/7/77

Detroit Veterinary Supply
1798 Wabash
Detroit, Michigan

For Periods ended: 8/31/65 – 11/30/76

Explanation: Pursuant to Section 1138 of the Tax Law, the Tax Commission may determine the amount of tax due when a return is not filed or when incorrect or insufficient information is given. Since you failed to supply requested information, the following taxes are determined to be due.

PERIOD ENDED	TAX	P & I	TOTAL
8/31/65	$12,000.00	$17,040.00	$29,040.00
11/30/65	12,000.00	16,680.00	28,680.00
2/28/66	12,000.00	16,320.00	28,320.00
5/31/66	12,000.00	15,960.00	27,960.00
8/31/66	12,000.00	15,600.00	27,600.00
11/30/66	12,000.00	15,240.00	27,240.00
2/28/67	12,000.00	14,880.00	26,880.00
5/31/67	12,000.00	14,520.00	26,520.00
8/31/67	12,000.00	14,160.00	26,160.00
11/30/67	12,000.00	13,800.00	25,800.00
2/29/68	12,000.00	13,440.00	25,440.00
5/31/68	12,000.00	13,080.00	25,080.00
8/31/68	12,000.00	12,720.00	24,720.00
11/30/68	14,000.00	14,420.00	28,420.00
2/28/69	14,000.00	14,000.00	28,000.00
5/31/69	14,000.00	13,580.00	27,580.00
8/31/69	14,000.00	13,160.00	27,160.00
11/30/69	14,000.00	12,740.00	26,740.00
2/28/70	14,000.00	12,320.00	26,320.00
5/31/70	14,000.00	11,900.00	25,900.00
8/31/70	14,000.00	11,480.00	25,480.00
11/30/70	14,000.00	11,060.00	25,060.00
2/28/71	14,000.00	10,640.00	24,640.00
5/31/71	14,000.00	10,220.00	24,220.00
8/31/71	14,000.00	9,800.00	23,800.00
11/30/71	17,000.00	11,390.00	28,390.00
2/29/72	17,000.00	10,880.00	27,880.00
5/31/72	17,000.00	10,370.00	27,370.00
8/31/72	17,000.00	9,860.00	26,860.00
11/30/72	17,000.00	9,350.00	26,350.00

PO BOX 577

MARCH 16, 1977

NEW YORK STATE
TAX COMPLIANCE BUREAU
STATE CAMPUS
ALBANY, NEW YORK 12227

DEAR SIRS:

IN RE NOTICE NUMBER 90,725,618 IN SUM OF $ 1,223,460.00

SINCE WE ARE A SMALL COMPANY NOT DOING BUSINESS IN NEW YORK STATE, YOUR REQUEST FOR $ 1,223,460.00 CAME AS A SURPRISE. WE THINK YOU HAVE THE WRONG COMPANY. AT ANY RATE, WE DENY BOTH LIABILITY AND ABILITY TO PAY.

YOURS,

W.F.HARLTON JR.

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
STATE CAMPUS
ALBANY, N.Y. 12227
STATE TAX COMMISSION

SALES TAX BUREAU
FRANCIS X. MALONEY
DIRECTOR
ADDRESS YOUR REPLY TO

Detroit Veterinary Supply Co.
1798 Wabash Avenue
Detroit, MI 48232

Attention W. F. Hariton, Jr.

Gentlemen:

We have found, during audits of veterinarians located in the State of New York, that your firm is selling veterinary supplies without collecting applicable State and local sales taxes.

As these sales are taxable in New York State, we requested on two occasions, that you register with this Bureau and begin collecting this tax.

Our letters were not answered - therefore, we issued an estimated assessment for tax, penalty and interest in accordance with section 1138 of our Tax Law. (Our Notice No. 90,725,618).

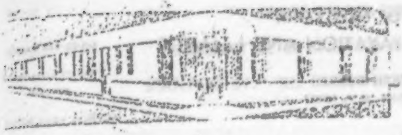
If our information is incorrect, please advise. Otherwise, we will expect to receive your application for registration within thirty days. We will hold collection action on Notice No. 90,725,618 in abeyance pending your reply.

Robert E. Hawkes

Robert E. Hawkes
Central Sales Tax Section
Telephone (518) 457-2445

MAY 15 1977

REH:vlb



DETROIT VETERINARY SUPPLY CO.
1700 Wabash Avenue, Detroit, Mich. 48232

(313) WO-1-6852 POBOX577

MAY 19, 1977

MR ROBERT E HAWKES
CENTRAL SALES TAX SECTION
STATE OF NEW YORK
DEPT OF TAXATION AND FINANCE
STATE CAMPUS
ALBANY, NY 12227

SIR:

IN ANSWER TO YOUR LETTER, SEE COPY ATTACHED; AND TO YOUR NOTICE NUMBER 90,725,618, SEE COPY ATTACHED.

YOU STATE WE HAVE NEVER ANSWERED YOUR LETTER, PLEASE SEE COPY OF OUR LETTER MARCH 16, 1977 WHEREIN WE POINTED OUT TO YOU YOUR REQUEST FOR

$ 1,223,460.00

WAS ABSOLUTELY RIDCULOUS.

WHATEVER SALES WE MAY HAVE MADE IN THE PAST INTO THE STATE OF NEW YORK WERE PURELY ON AN OCCASIONAL BASIS. (ONCE OR TWICE A YEAR). THESE WERE STRICTLY INTERSTATE COMMERCE SALES SINCE WE HAVE NO ESTABLISHMENT IN NEW YORK, NOR DO WE HAVE ANY SALESPEOPLE IN NEW YORK. NOR, ARE WE MAILING ADVERTISING INTO NEW YORK.

CURRENTLY WE DO NOT ANTICIPATE ANY FUTURE SALES INTO NEW YORK.

UNDER THE CIRCUMSTANCES, WE BELIEVE A SALES TAX LICENSE WOULD BE UNNECESSARY.

YOURS,

W.F. Harlton Jr

W.F.HARLTON JR.

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
STATE CAMPUS
ALBANY, N.Y. 12227
STATE TAX COMMISSION

SALES TAX BUREAU
FRANCIS X. MALONEY
DIRECTOR
ADDRESS YOUR REPLY TO

Detroit Veterinary Supply Co.
1798 Wabash Avenue
Detroit, MI 48232

Attention Mr. W. F. Harlton, Jr.

Gentlemen:

Thank you for your letter of May 19, 1977.

Based on the explanations furnished, we are withdrawing our demand that your firm register with this Bureau. Accordingly, assessment #90,725,618 has been cancelled.

Robert E. Hawkes
Central Sales Tax Section
Telephone (518) 457-2445

JUN 14 1977

REH:ds

best copy available

SENATE FINACE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

STATEMENT BY: THE DIRECT MAIL MARKETING ASSOCIATION ON:

S 983
INTERSTATE TAXATION ACT

JULY 24, 1980

Mr. Chairman,

The Direct Mail Marketing Association is a trade association consisting of more than 2,000 companies and 3,500 individuals involved in every form of direct response marketing.

This Committee undoubtedly knows and will likely be told repeatedly during these hearings that the House has twice passed, by an overwhelming majority legislation similar to S. 983 insofar as it affects those of us in the direct mail order business. For more than a decade the Senate has, unfortuntely not seen fit to follow the steps taken by the House. We are hopeful these hearings lead to a concurrance with the House's endorsement and we are grateful that our Association of Direct Mail Marketers has been invited to present its case.

II. Case for Uniformity

The number of firms engaged in some form of interstate commerce in this country is close to 200,000 and the majority of these firms have less than one million dollars of annual sales. Approximately half these companies employ fewer than 20 persons on a full time basis.

The typical interstate business is not a corporate giant with a large tax department and refined electronic data processing equipment nor does the typical company have access to the staff of accountants and lawyers necessary to decipher the various tax code intricacies.

Yet, small multistate mail order businesses must contend with the bookkeeping and paper work costs of a myraid of sales and use taxes in 45 states and the District of Columbia as well as literally thousands of municipal and local tax jurisdictions.

The laws of the various political subdivisions are confusing and burdensome.

(a) Sales tax returns may have to be filed annually, quarterly and monthly; some are filed 15 days before the end of the period; some 15 days after. Some returns require prepayment, others do not.

(b) The rates vary considerably and are subject to change.

(c) All states do not tax all products uniformily. Exemptions vary and often involved obtaining exemption certificates.

(d) Tax audits are an obvious burden to a small firm.

The costs are varied and considerable.

(a) A staff of attorneys and tax experts with back-up services (libraries, etc.) are needed to process existing laws and keep abreast of new laws and amendments.

(b) Computer costs - hardware and software. Each change in a law requires a separate program.

(c) Filing costs, i.e. time, personnel, licenses, fees, etc.

(d) Customer service costs.

(e) Losses incurred by customer underpayment.

The above costs constitute a substantial burden on interstate commerce as mail-order fimrs are reluctant to enter adjoining State because of tax consequences. It should be stressed that once in a State the requirements are absolute, no matter the number of sizes, the size of the manufacturing operations or the amount of property owned.

As related above, the House has recognized the urgency of this problem and previously passed legislation similar to S. 983. In its decisions affecting interstate commerce the Supreme Court has attempted to establish some rational basis for a constitutional taxing nexus.

In National Nellas Hess, Inc. v. Department of Revenue, the Court warned that the many variations in rates of tax, allowable exemptions, and in administrative and record-keeping requirments could entangle an interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate interest or right to impose upon the business a share of the cost of local government.

In National Geographic Society, v. California Board of Equalization, the U.S. Supreme Court rejected the position of the California Supreme Court that only the "slightest presence" in a state was sufficient constitutional nexus. The U.S. Supreme Court required a much more substantial presence to establish the legitimacy of a claim for tax collection liability.

Finally, in Moorman Manufactoring Co. v. Blair, it is apparent that both the majority opinion of Mr. Justice Stevens and the minority opinion of Mr. Justice Blackman are inviting Congressional action in this area.

pages tightly bound

III. A Possible Solution

A good tax system has as its keystone the principal of certainty. We beleive the uniform system for the taxation of interstate commerce would, at least, permit filings to be based on a single set of rules. The proposed definitions and standards of S. 983 will aid in bringing about this uniformity. We would like to amplify and comment upon certain sections of this bill.

First, a most important feature of S. 983 with respect to interstate sales and use taxes is Title 1 setting forth uniform jurisdictional standards. The bill provides that no state or political subdivision shall have power to require a seller to collect a sales or use tax with respect to an interstate sale unless the preson has a business location in the state or regularly makes household deliveries in that state. This most significant and highly appropriate provision establishes solid guidelines of states and interstate mailers to determine when and where a particular transaction is subject to tax.

We submit there remains a point of clarification needed here. The state should not be able to combine separate and distinct activities of corporate entities under common ownership. Taxing only the affiliate or parent coproration which is actually present and doing business in the state will encourage interstate operators to become more involved without fear of complications of tax matters of out of state affiliates engaged in diverse operations.

We further submit Section 102 (c)'s $20,000 limitation is not adequate due to inflation and for the fact that it fails to distinguish between the market potential of states of varied size. Any standard limitation presents problems and we'd like to suggest a sliding scale based upon population. This would allow flexibility in establishing a uniform limitation corresponding to equal population characteristics in a particular state.

Second, we strongly endorse the concepts of Title II as it seeks to insure that there is a reasonable nexus between a taxing jurisdiction and a business outside the jurisdiction sought to be taxed. Under Title II of S. 983, a company must have a business office in the State in order to be taxed under the State's gross receipts tax.

Third, one of the most perplexing and frustrating areas of state taxation is the allocation and apportionment of income among the various states for purposes of determining a multistate corporation's proper income tax liability to the respective states. We believe Title III addresses this problem but does not go far enough.

We submit the Title III could be improved if it were to include provisions similar to Section 201 in Title II to the effect that a company must have a business office in the taxing state in order to be taxed on its net income. While it is true that Title III includes a property factor in its optional three-factor formula, there appears no requirement that the taxpayer actually own or lease property in the State. In our view, the nexus requirement for a net income tax should be the same as that for a gross receipts tax.

We also wish to specifically and strongly endorse the concept of "equally weighed" property, payroll and sales factors.

Fourth, Section 302 eliminates from the tax base dividends paid by subsidiaries. The subsidiaries pay their own taxes and there is no reason for their earnings to be taxed twice.

Fifth, Section 303 permits apportionable income, at the option of either the State or the taxpayer, to be determined by reference to the combined or consolidated income of all subsidiaries of an affiliated group of which the taxpayer is a member.

We submit the restrictions in Section 303 on consolidated returns are inadequate. A state should never be permitted to force consolidation.

We further submit that affiliated corporations should be defined as follows:

> **"Two or more corporations are affiliated if they are members of the same group comprised of one or more corporate members connected through a unity of stock ownership, operation and use and in effect are a unitary business."**

For purposes of the above, the unitary (or "whole company") business would possess the following elements - unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting, and unity of use in the centralized executive force and general system of operation.

Sixth, we strongly endorse Title IV of S. 983 which would provide for uniform judicial interpretation and would relieve taxpayers of the burdens of litigation in a multiplicity of jurisdictions. The single Federal Court would develop an expertise in the interpretation of laws relating to the taxation of interstate commerce not possible under our

system of litigating such matters and would assure a uniform application of law, thus providing the certainty required by interstate business in determining tax collection liability.

IV. Summary

Throughout the hearings on both S. 2173 and S. 983, critics of the overall thrust of this legislation have attacked it as providing immunity from regulations or taxes in return for benefits received. In effect, mail order houses would operate from "privileged sanctuaries."

We believe this argument is deficient when subjected to the realities of interstate commerce today. It is simple to say if local retailers can determine, collect and remit sales taxes, why can't direct mail marketers? A local retailer needs to know only one sales tax law. All sales, not exempt, are subject to the same condition. But a direct mail marketer operating nationally is asked to be the tax collector for thousands of taxing bodies.

The cost and accuracy burden upon the interstate direct mail marketer is wholly disproportionate to the local retailer as are the benefits if any or the lack of same received. The direct mail marketer solicits its orders by mail and the goods are delivered by the U.S. Postal Service or United Parcel Service. Neither our customers nor our firms impose any burden or costs on foreign states in which we sell by mail. We also receive no benefit from the services of the foreign state. Being taxed where we impose no cost and receive no benefit is wholly inequitable.

Nevertheless, as taxing entities become increasingly hungry for revenue, their discrimination argument will increase. An out-of-state firm has no constituency in a state and so their argument cannot be answered through the local political process but only through the national forum - Congress.

A significant idea embodied in our concept of federalism is Article I, Section 9 which states "No state shall, without the consent of Congress, lay any Imposts or Duties on imports or exports. . ." The framers were well aware of the limitations and restraints of free trade caused in Europe by the multitude of borders, tarriffs, tolls and taxes between the nations. They sought to embody the idea in the Constitution that our States should not create trade barriers between themselves. S. 983 will endorse such constitutional mandate and we urge the Senate to give utmost priority to passage of this vital legislation.

Thank you for your kind consideration of our position.

Mr. Keeley. Thank you, Mr. Chairman.

Some years ago, in 1964, the Willis Committee report concluded that the State system of taxation was one that worked badly for both business and the States. It was characterized as a system in which the States are reaching farther and farther to impose smaller and smaller liabilities on more and more companies. It was also depicted as a system which calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliable.

Sixteen years have passed since that Willis report came out, and the situation is as bad as it was then, and perhaps much worse. Senator Mathias had testified earlier on the proliferation of taxing units, mainly political subdivisions, which are counties and cities and police jurisdictions and not States.

This system has created a very complex situation which hits particularly hard small interstate businesses. We have in our written testimony included and summarized many of the problems that these small businesses are facing today, and I won't burden you or the record with a repetition, but I would like to point out the encounter which Mr. Harlton of the Detroit Veterinary Supply Co. had with the State of New York recently.

His company had no place of business or salesperson traveling in that State, but he did make one mail order sale into New York. As a result of that single isolated sale, he was assessed $1.2 million for past use tax obligations, and he was subjected to this unfounded tax assessment for over 4 months before it was finally withdrawn by the State of New York.

This is detailed in his written statement, which we have submitted for the record.

In conclusion, we would just request the subcommittee to act quickly on the very serious problem in the sales and use tax area which interstate businesses, especially small businesses, are now facing. Thank you, Mr. Chairman.

Senator Byrd. Thank you, Mr. Keeley.

How much was the mail order sale that caused a million in taxes?

Mr. McCamant. I think I can answer that. I think his total business was around $500,000 a year, and he received an assessment first of around $16, and he didn't answer it, and then pretty soon they decided to go back for 10 years, and they raised it, and pretty soon he was faced with an assessment of over $1 million, which, of course, if it had gone through the courts of New York, could have been served, I believe, through the courts in the State of Michigan. I don't believe the State of Michigan courts would have looked into the merits of the case.

One of the things that people say is, "death and taxes are certain, but the tax is not certain," and that is what Senator Mathias mentioned. They are sitting on a time bomb. They really don't know what their taxes are, and some day they can go back for a period of 10, 12, or 15 years, and that is what the State of New York did.

Senator Byrd. What happened to that $1 million——

Mr. Keeley. The proposed assessment was finally withdrawn by the taxing authority in New York, after some lengthy correspondence which went back and forth from the company and the taxing officials, but it is interesting, in one of the letters that is attached to Mr. Harlton's statement from the taxing authorities in New York, the statement was made that they had a right to tax any sale that was made into the State of New York.

Of course, this is not constitutionally correct, but then Mr. Harlton was no constitutional lawyer. He did resist. Finally, after 4 months, the assessment was canceled.

Senator BYRD. If it is unconstitutional, you don't need a law.

Mr. KEELEY. Well, we submit that if there was a law on the books, Federal legislation which would clearly delineate the jurisdictional reach of a taxing authority, that perhaps the State taxing authorities would not go to the extreme and the lengths that they did in the case of the Detroit Veterinary Supply Co.

Senator BYRD. Thank you.

Mr. Webster?

STATEMENT OF GEORGE D. WEBSTER, GENERAL COUNSEL, AMERICAN APPAREL MANUFACTURERS ASSOCIATION, ACCOMPANIED BY G. STEWART BOSWELL, DIRECTOR, GOVERNMENT RELATIONS, AAMA

Mr. WEBSTER. Mr. Chairman, my name is George D. Webster. I am an attorney in Washington, D.C. I am accompanied by Mr. Stewart Boswell, director of government relations for the American Apparel Manufacturers Association. I am here today on behalf of that association and one of its member companies, the Haggar Co. of Dallas, Tex., to urge passage of S. 983.

I have two statements, Mr. Chairman, that I would like to submit for the record, and I will make a short summary statement.

Senator BYRD. Without objection, so ordered.

Mr. WEBSTER. At present, there are few restrictions on the rights of States to tax interstate businesses. One Supreme Court decision allows the State to impose a gross receipts tax on businesses that employ only one person in the State, and that person need not even solicit orders or have an office outside his home.

States also are given great leeway in assessing net corporate income taxes.

The apparel companies consider the current state of affairs with regard to State taxation of interstate commerce to be chaotic, inequitable, and generally unsatisfactory. The lack of a consistent standard among the States as to which businesses can be taxed precludes effective long-range business planning.

The heavy amount of paperwork required by the States interferes with industry efforts to keep prices at low levels. The lack of a meaningful nexus requirement between the level of a firm's activity in a State and the State's right to tax that firm allows a State to impose taxes even when business activity within the State is at a bare minimum.

The Haggar Co. and the American Apparel Manufacturers Association believe that S. 983 will correct the abuses that I have described. It provides one definite standard for determining what level of contact a business must have within a State before a use tax or gross receipts tax can be levied.

Two, it prevents a State from taxing a business that has only minimal contact with that State. Third, it reduces the amount of paperwork to be done by firms, and it eases the administrative burden on interstate businesses. Finally, it removes the worst feature of the net income tax, the right of States to tax the foreign income of a company.

The optional three-factor formula in the bill is straightforward and easily interpreted. It will protect companies against excessive, irregular, and indiscriminate State taxation of corporation income.

In conclusion, we support S. 983 and urge this committee to act favorably on it.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Webster.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman. I am sorry, I have been in a Commerce markup. We just finished.

Senator BYRD. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT
on
STATE TAXATION OF INTERSTATE COMMERCE AND WORLDWIDE INCOME
before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY
of the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Charles W. Wheeler
June 24, 1980

My name is Charles W. Wheeler. I am the Senior Tax Attorney at the Tax Policy Center of the Chamber of Commerce of the United States, on whose behalf I am appearing today. The U.S. Chamber is the world's largest business federation, comprised of more than 94,600 businesses, 2,700 chambers of commerce in the United States and abroad, and 1,300 trade and professional associations. On behalf of our more than 98,600 members, we welcome this opportunity to support legislation such as S. 983 that would provide uniform rules for state taxation of interstate commerce and S. 1688 and S. 983 that would prevent the continued use by certain states of the worldwide combined reporting system.

SUMMARY

For a business, large or small, operating in several states and their many political subdivisions, the problems of tax compliance can approach the impossible. Not only do the tax laws differ from state to state, but in some cases, from locality to locality. Vague provisions in the applicable laws, uncertain interpretations, unwritten local practices, and other obstacles can make a business's tax compliance problems a nightmare. For years the U.S. Chamber has advocated action by the Congress, under the Interstate Commerce Clause of the Federal Constitution, that would establish uni-

form jurisdictional standards for the imposition of taxes by the states upon interstate business, promote uniformity in the division among the states of interstate business income and in the tax base for income tax purposes, and promote uniformity in definitions of common terms and common standards used by the states in the imposition of the obligation on interstate sellers to collect sales and use taxes.

The adoption of S. 983 would provide much of this badly needed uniformity. The states would be assured that business was paying its fair share of the tax burden and their enforcement costs could be reduced. Business would be relieved of the threat of double taxation and of a great paperwork burden. It is for these reasons that the U.S. Chamber generally supports S. 983.

The problem of state taxation of income from foreign subsidiaries and affiliates of corporations operating within a state must be given special consideration. The majority of states recognize that the earnings of those foreign corporations bear no relationship to the business activities carri on within their borders. A few states, however, have subjected these foreign earnings to tax by adopting the worldwide combined reporting system. While combined reporting can fairly apportion income earned within the U.S. to the various states, its extension to worldwide income often results in international double taxation.

United States international trade policy has long been opposed to international double taxation in the belief that taxes should be a neutral factor in the flow of goods and services between nations. Allowing any state to subject income earned abroad and bearing no relationship to activities within the state to tax not only violates this policy but threatens the ability of the United States to establish such a policy.

Both S. 983 and S. 1688 would prevent the possibility of international double taxation. S. 983 would prohibit the states from taxing any foreign source income and S. 1688 would prevent the states from taxing any income that is not already subject to U.S. tax. Each would ensure that the international trade policies of the United States are determined at the federal level. The continued use of the worldwide combined reporting system by the states must be stopped. The U.S. Chamber thus supports both S. 983 and S. 1688.

STATE TAXATION OF INTERSTATE COMMERCE

Advances in communication and transportation in this country have brought us to a point where a huge segment of American business is operating in interstate commerce. Most large and medium sized businesses find that their commercial activities necessarily extended across state lines. Many retail establishments find that customers are requesting deliveries of merchandise to other states. Even small manufacturers are doing business in large numbers of states. As a business extends its operation into other states, liability for taxes in those states follows. But the rules under which interstate businesses are subject to the taxes of the various states are voluminous and often vague. Many of the rules must be extracted from often confusing court decisions rather than from statutory law or regulations.

Frequently it is the small businessman that is hardest hit. Desiring to expand commercial activities into other states, it often finds the greatest obstacle to be tax compliance. The business must know the tax laws of each jurisdiction in which its products or service are sold. Not only do states have income, gross receipts, and sales taxes, but so do local jurisdictions. Often the business must file income tax returns and remit sales taxes not only in several states, but in many local jurisdictions as well.

This problem is not new. The most comprehensive study of state taxation was begun in 1961 by the Special Congressional Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary of the House of Representatives. The Subcommittee held extensive hearings in 1961 and 1962 and presented its final report in 1965. The Subcommittee's study had this comment on how it found the system of state taxation of interstate commerce to be operating:

> It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach to the taxation of interstate companies as it appears in State and local law, and the practical difficulties of realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States.
>
> House Report No. 952, Vol. 4,
> p. 1127, 89th Cong., 1st Session (1965).

S. 983

The adoption of federal legislation such as that contained in S. 983 would be a major step toward solving the problems found by the Special Congressional Subcommittee. Title I of the bill sets out jurisdictional standards for imposing sales and use taxes. A business will be subject to such taxes only if it has a business location, regularly solicits orders by means other than direct mail, radio, or television, or regularly makes deliveries by means other than the U.S. mail or common carrier in the state or locality imposing the tax. A company is considered to have a business location in each state where it owns or leases real property, has one or more employees, or regularly keeps tangible personal property for sale to customers in the ordinary course of business. The possibility of multiple taxation would be prevented by limiting a state's authority to tax to sales with a destination in that state.

Companies with less than $20,000 in annual sales and no business location in a state would not be required to collect any sales or use tax from customers in that state. Companies with less than $100,000 in annual sales and no busiess location in a state would be able to participate in a buyer certification plan. Under such a plan, the seller would only be liable to collect the amount of sales or use taxes certified by the purchaser. If the seller had actual knowledge that the tax rate or amount certified by the purchaser were false, the seller would be liable for the correct amount. If the purchaser failed or refused to certify the amount or rate of tax, the seller would collect a tax at the highest combined sales or use tax rate applicable to that state.

Other provisions would settle more narrow issues. A seller would not be required to classify sales geographically. The right of a state to impose sales or use taxes on the sale of motor fuels or the registration of motor vehicles and boats would not be restricted. Separately stated freight charges could not be included in that tax base. A state could impose a use tax on tangible property used in the state. The seller would be relieved of liability for the noncollection of a sales or use tax if the buyer has furnished proof of exemption.

Title II of S. 983 would limit the power of a state or local government to impose a gross receipts tax. Such a tax could be imposed on interstate sales of tangible personal property only if the sale were directly solicited through a business office of the seller in the jurisdiction imposing the tax. A seller would be considered to have a business office in a state or local political subdivision only if it owned or leased real property in the area or maintained within the jurisdiction a stock of tangible personal property for sale in its ordinary business activities.

Title III of S. 983 places a ceiling on the amount of income from a corporation's interstate business that a state or local government can tax. This ceiling is determined through the use of the three factor apportionment formula set forth in the bill. Nothing in the bill requires a state or local government to use this formula. It merely prevents a state or local government from imposing its tax on more income than would be apportioned to that state or locality under the formula.

The three factors used in the formula are property, payroll, and sales. The property factor is determined by dividing the average value of the corporation's real and tangible personal property used in the state by the average value of such property located everywhere. The payroll factor is determined by dividing the wages paid by a corporation to employees in a state by the total wages paid everywhere. The sales factor is determined by dividing the total sales within a state by the total corporation sales. A sale of tangible, personal property is considered to be made in the state where actual delivery takes place. A sale of realty occurs where the real state is located. Sales of services are where the services are performed. If services are performed in more than two states, then the sale is divided between them.

The dividend income from a company in which the taxpaying corporation owns less than 50 percent of the voting stock is allocated to the corporation's state of commercial domicile. The dividend income from a company in which the taxpaying corporation owns 50 percent or more of the voting stock is neither apportioned nor allocated.

Either the state or the taxpaying corporation may elect to have the corporation's U.S. source taxable income determined on a combined basis. Corporations are considered affiliated, and thus subject to combination if more than 50 percent of the voting stock of each corporation in the group, other than the common parent, is owned directly by one or more of the other members and the common parent owns more than 50 percent of at least one of the corporations.

Title IV of S. 983 would give the U.S. Court of Claims jurisdiction over disputes arising under the bill. This would help to ensure that the uniform treatment of both the states and business provided by the bill would remain uniform. Title V of the bill would prohibit states from imposing charges for conducting out-of-state audits.

The adoption of the uniform standards contained in S. 983 should reduce substantially the conflicts between state taxing authorities and the business community. For example, an interstate mail order company would know precisely when it is and when it is not liable for the collection of sales and use taxes. Its paperwork burden would be reduced by not having to classify sales geographically. A manufacturing concern would no longer have to worry that the income from a sale would be taxed twice, once by the state from where the item is shipped and again by the state where the item is delivered.

State taxing authorities also would benefit from the uniformity

provided in S. 983. The elimination of much of the conflict between the state authorities and business should reduce compliance costs. It also should increase compliance, since businesses will understand more clearly what their tax liability is, and to whom it is owed. For these reasons, the Chamber supports the adoption of uniform standards for state sales and use, income, and gross receipts taxes.

WORLDWIDE COMBINED REPORTING SYSTEM

The issue of how a state may determine the amount of taxable income of a business engaged in international operations merits special attention. The basic principle under which a state is allowed to tax the interstate activities of a multistate business was set forth by the U.S. Supreme Court in Northwest States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959). In that case the issue was whether Minnesota could tax the income of an Iowa corporation from business activities carried on in Minnesota. The court stated that such income "may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." The use by certain states of the worldwide combined reporting system (hereafter called WCRS) violates this principle by subjecting to tax income from international operations that has no relationship to the taxing state.

WCRS is the method used by a few states to determine the amount of income of a multinational enterprise subject to tax within those states. WCRS rests on the theory that the various subsidiary and affiliated corporations of a multinational business really form part of a single enterprise. This allows a state to determine the net income of the entire

peration and then to tax a percentage of that total income based on the ratio the business activities within the state bear to the business activities of the entire organization. This generally is done by comparing the value of property, payroll, and sales within a state to the total value of these items worldwide.

Worldwide Combined Reporting Produces International Double Taxation

The theory of WCRS assumes that the business earns the same rate of return for every dollar of property, payroll, and sales. While this assumption may work reasonably well for apportioning domestic income among the various states, it does not operate well on a worldwide basis. The difference in pay between U.S. workers and foreign workers can be far greater than any differences found within the United States, yet the productivity of the foreign worker may equal or exceed his domestic counterpart. The profits that must be earned to justify building a new plant in a foreign country may be far higher if a danger of expropriation exists. When the return on investments in overseas operations, based on property, payroll, and sales, is higher than that being earned from those factors in the taxing state, the use of WCRS will apportion more income to the taxing state than is actually earned. When the return from investments in the taxing state is higher, WCRS will apportion less income to the taxing state. Other witnesses will undoubtedly provide many illustrations of these problems.

A second concern with the use of WCRS is the lack of a precise definition on how the combined income should be apportioned. The states that use combined reporting for domestic source income have come up with a variety of definitions. One state uses a single factor, sales, to determine the ratio of instate activities to out-of-state activities. Others use the three factors discussed above, property, payroll, and sales, but give added weight to the sales factor. Even the definition of what should be included within the factors varies. Some states include all sales where delivery occurs within their borders while others include all sales that are shipped from within their borders.

The various means used to apportion the combined income within the U.S. can lead to double taxation. There are two considerations in the U.S., however, that help to prevent this from occurring on a large scale. The first is the ability and oft-stated willingness of the U.S. Supreme Court to strike down a state law that actually results in double taxation. The second is the ability of Congress to prevent double taxation by enacting uniform rules under which the states could tax interstate commerce.

On the international level there is no agency or body with the power to ensure uniformity in apportionment. Developing countries that adopted WCRS could place added weight on the sales factor and define it to include deliveries within their borders. Industrial nations could define sales to mean the shipment of goods. The double taxation that would inevitably result could not be controlled except by a series of agreements among all taxing nations which would be extremely difficult to achieve.

Worldwide Combined Reporting Does Not Simplify Auditing

Many state taxing authorities have stated that the use of WCRS is far simpler than the use of an arm's length accounting standard such as that contained in section 482 of the Internal Revenue Code in trying to determine the income earned by a business enterprise within a state. While there are difficulties in making arm's length adjustments at the international level, the problems of using WCRS are even greater.

The use of WCRS first requires a determination of which subsidiaries and affiliates of the business enterprise are part of a single unitary business. This determination is highly subjective and can be subject to numerous challenges. Because no two businesses operate in exactly the same manner, the development of objective standards is unlikely to result even with extensive litigation. The use of arm's length accounting on the other hand, does not require the determination of a unitary business.

The use of WCRS requires the combination of the profit statements of all of the various subsidiaries and affiliated corporations of the business enterprise that have been found to be part of a single business. This must be done in accordance with the accounting rules of the taxing state. Each of the subsidiaries and affiliates, however, keeps books and records in accordance with the laws of the nation in which it operates. Unless the taxing state is willing to accept the records furnished by the business enterprise, it must audit both the original books and records of all of the various subsidiaries and affiliates and the procedures used to conform those records to the taxing state's accounting rules. In contrast, the use of the arm's length method for international transactions only requires the taxing state to examine transactions between the companies in the U.S. and abroad.

The bookkeeping problems of a multinational business also would be simplified by the use of an arm's length accounting standard. The process of adjusting business records from one accounting system to another is difficult. It is complicated further when one nation requires records not necessary under laws of the other. An example would be requiring records on the cost basis of depreciable equipment when the other country allows immediate expensing. The use of WCRS by more states would compound the difficulties faced by a business in conforming its books and records. Foreign countries also may prohibit a business from turning over its books and records under certain circumstances.

Worldwide Combined Reporting Prevents Adoption Of A Uniform International Trade Policy

Under our constitutional system, it is the federal government and not the states that establishes foreign policy. The regulation of international trade is an important element of that foreign policy. Chaos would result if each of the 50 states was able to establish, for example, its own tarriff barriers and export regulations. The increasing use of WCRS by the states is likely to produce similar problems.

The U.S. policy toward international trade has been to promote the free flow of goods and services across international boundaries. The U.S. has recognized that taxation can be an important factor in hindering or promoting international trade and has endeavored to make it a neutral factor. One of the most important aspects of that endeavor has been the prevention of double taxation through tax treaties and the foreign tax credit. The double taxation that often results from the use of WCRS, however, runs directly contrary to those efforts.

The continued acceptance of WCRS by the U.S. also may encourage other countries to adopt it. This would be an even greater threat to U.S. efforts to make taxes a neutral factor in international trade. Currently, the use of arm's length accounting is the accepted international standard for determining whether income is earned in one nation or another. This standard also allows outstanding differences to be settled between the nations claiming a right to tax the income of a given multinational company through the use of tax treaties. If WCRS were used by either nation, it would be impossible to settle those differences through bilateral treaties, but would require agreement among all nations in which the multinational operated, an extremely unlikely event.

Worldwide Combined Reporting Should be Prohibited

The continued use of WCRS by the states represents a clear threat to the ability of the United States to speak with one voice in the development of international trade policy. The international double taxation that results from WCRS can be demonstrated. Its use by more states would compound the problem. In addition, the spread of WCRS to other states would further complicate the already difficult accounting procedures it requires.

S. 983 would prevent the use of WCRS by preventing the states from taxing any foreign source income. S. 1688 would prohibit the use of WCRS but would allow the states to tax foreign source income that was taxable at the federal level. The adoption of either S. 983 or S. 1688 would stop the threat of international double taxation and ensure that the United States has a coherent international trade policy.

State Taxation Of Foreign Source Dividends

Presently, those states that use WCRS do not include the dividends received from subsidiary corporations in determining the income subject to tax. If WCRS is prohibited, it is likely that those states will attempt to include the dividends received from overseas corporations in the tax base. As a conceptual matter, these dividends should not be subject to tax at the state level. The income from the overseas subsidiary was not earned by activities within the taxing state, and to prevent international double taxation should not be subjected to its taxation.

This conclusion is not affected by the recent decision of the U.S. Supreme Court in Mobil Oil Corporation, v. Vermont, ___ U.S. ___ (1980). The court took great care to point out that Mobil had not asked the court to decide whether the burden on international commerce from taxing dividends from overseas subsidiaries should prevent any state from taxing foreign source dividends. It stated, "Mobil suggests that dividends from foreign sources must be allocated to the State of commercial domicile, even if dividends from subsidiaries and affiliates operating domestically are not. By accepting the power of the State of commercial domicile to tax foreign source dividend income, appellant schews the broad proposition that foreign source dividends are immune from state taxation." And, again, that"By admitting the power of the State of commercial domicile to tax foreign source dividends in full, Mobil necessarily forgoes (sic.) any contention that local duplication of foreign taxes is proscribed."

S. 983 recognizes that foreign source dividends are not earned in any state and prohibits any state taxation of such income.

As a practical matter, however, many countries of the world impose taxes at rates lower than those imposed by the United States. S. 1688 recognizes this fact by allowing the states to tax the same portion of the dividend that is taxable at the federal level. This ensures that the earnings of the overseas subsidiary do not escape tax but will prevent international double taxation.

CONCLUSION

The need for the Federal government to impose some degree of uniformity on the methods states use to tax interstate commerce is clear. The inequitable and inefficient pattern of state taxation found by the Special Congressional Subcommittee in 1965 has not been lessened.

The adoption of federal standards, however, should not be seen as a limit on the taxing authority of the state. Each state would still be able to set its own tax rates and to determine whether it should raise revenue by sales taxes, income taxes, severance taxes, or gross receipts taxes. The adoption of S. 983 merely would ensure that a business operating in interstate commerce would not be subject to multiple taxation and overly burdensome compliance costs.

Moreover, the continued use of worldwide combined reporting by certain states threatens the ability of the United States to adopt a single international trade policy. The extension to all states of the single arm's length accounting standard used by the federal government would ease greatly the administrative burdens on both the states and multinational businesses. The adoption of either S. 983 or H.R. 5076 would prevent the continued use of WCRS, would ensure that the United States has a coherent international trade policy, and would simplify the accounting and auditing procedures of the states.

Summary of Principal Points

Testimony of Thomas J. McHugh

On Behalf Of

The National Association of Manufacturers

"State Taxation of Income from Interstate Commerce"

Sales and Use Taxes

- **The present system of state and local sales and use tax collection is essentially unworkable. Hundreds of thousands of small and medium sized businesses continue to run the risk of unknown sales and use tax liabilities in states where they own no property, have no employees, or make no regular deliveries.**

- **S. 983 provides a simplified sales and use tax compliance system which protects the small and medium sized seller while safeguarding the state sales tax revenue base.**

Income Taxes

- **Currently, most states use a formula to apportion the income of the multijurisdictional taxpayer. However, variations in the make-up of the formula expose taxpayers to the risk of multiple taxation of income as states attempt to export their tax burden to out-of-state firms. S. 983 establishes a uniform formula for the division of income.**

- **The use of the "worldwide combination" system of defining income distorts the proper apportionment of income and imposes administrative difficulties of the highest order.**

- **As a general rule, we believe that states should not tax income from foreign sources. The link between activities within a state and foreign source income is tenuous at best. And, the entry of states into international tax matters can have unfavorable effects on both international commerce and federal foreign policy.**

- **As a compromise to the question of state taxation of income from foreign sources, we would support S. 1688 which permits states to tax foreign dividends at the time and to the extent that the federal government taxes those dividends.**

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TESTIMONY OF

THOMAS J. MCHUGH

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

U.S. SENATE FINANCE COMMITTEE

June 24, 1980

"State Taxation of Income from Interstate Commerce"

My name is Thomas J. McHugh and I am the Vice President-Taxes of Kraft, Inc. I am testifying today on behalf of the National Association of Manufacturers in my capacity as Chairman of NAM's Taxation Committee.

The bills which are the subject of this hearing are S. 983 and S. 1688. The former is a comprehensive approach to state taxation of income from interstate commerce while the latter is more narrowly focused on the taxation of income from foreign sources. The NAM supports S. 983 as a reasonable step toward the solution of the large number of difficult problems associated with state sales and use, income, and gross receipts taxes. Even though S. 983 covers state taxation of income from foreign sources as well as income from domestic sources, the particular problems of worldwide combination and the taxation of dividends from foreign sources may justify specialized treatment. Consequently, we also support S. 1688 as a compromise approach.

The lack of uniformity among the states and between the states and the federal government presents a significant obstacle to the free flow of commerce and competition across state lines. The lack of comprehensive reform of state and local taxation has resulted in an avalanche of unnecessary paperwork for businesses of all sizes, has harmed the competitive posture of U.S. firms in the world market, and has set the stage for the fractionalization of the United States through interstate trade barriers and burdens. Both S. 983 and S. 1688 would tend to lessen the trend toward trade protectionism now growing among the states.

In my testimony today, I will briefly address the innovative sales and use tax provisions in S. 983 and then move on to the income tax provisions of both S. 983 and S. 1688.

Sales and Use Taxes

While most of the debate on state taxation of interstate commerce has focused on the complex and intriguing issues related to income taxes, it is important to realize that the states receive more than five times as much revenue from sales taxes than from corporate profits taxes. Recognizing the importance of sales tax revenues, S. 983 sets forth a new plan for sales and use tax compliance. This plan has the potential to increase revenues to the states as a result of greater sales tax compliance, rather than decrease receipts due to the erection of jurisdictional barriers.

The problem posed by the sales and use tax collection obligation is less substantive than administrative. Sales taxes are added to the price of goods and the tax burden is borne by purchasers. Generally, sellers are not reluctant to collect and remit a sales or use tax provided the procedure is readily understandable and administratively workable.

Unfortunately, the reality of sales tax compliance and administration fall far short of this ideal. Each state may have its own sales tax rate, its own definition of taxable and non-taxable sales, its own tax form and filing system. While it may be theoretically possible for a seller to keep track of the statutes and regulations of the fifty states and the District of Columbia, the addition of every city, county, transit district, school district, and other jurisdiction which may impose a tax on sales makes the present system practically unworkable.

Most prior drafts of interstate tax legislation have addressed this problem by limiting the states' power to impose an obligation to collect a sales or use tax. For example, the Special Subcommittee on State Taxation of Interstate Commerce of the House Judiciary Committee (the "Willis Committee") in its landmark 1964 report recommended that a state be precluded from requiring a seller to collect a sales or use tax unless the seller owned or leased realty in the state, had an employee in the state or made household deliveries in the state. Interstate tax legislation which has twice passed the House of Representatives imposed similar jurisdictional standards. Nonetheless, S. 983 takes a much more moderate approach. Under the bill, "out-of-state" sellers would remain obligated to collect and remit sales and use taxes. However, these sellers could elect to have the purchaser certify the amount of tax applicable to the transaction. That amount could then be remitted to the state via a standard form prescribed by the U.S. Department of Commerce.

This "buyer certification" election would be available only to those who had less than $100,000 in taxable sales in the state and who did not otherwise have a business location within the state. Since larger businesses tend to have business locations within their major market states, this election would be generally restricted to the small businesses now unable to cope with the complexities of interstate sales and use tax laws. For the smallest sellers, i.e., those with less than $20,000 in taxable sales in a state, the collection obligation would be relieved entirely. A further explanation of the major provisions of title I of S. 983 is attached.

Income Taxes

A major problem facing both states and taxpayers is the proper division of income for those taxpayers which operate in more than one jurisdiction. Historically, the method used to accomplish this division has been the separate accounting method. Under separate accounting the various units or subsidiaries of a taxpayer are examined individually so as to determine the particular income and expenses of each. To the extent that products or services are transferred between related entities at other than fair market value prices, the division of profit is redetermined as if the parties were dealing with one another at arms-length.

Essentially all national governments use the separate accounting method for tax purposes. In the U.S. system, the basic adjustments required for the separate accounting system are found in sections 482 (relating to adjustments among related taxpayers) and 861 (relating to the proper sourcing of income) of the Internal Revenue Code.

In order to apportion the income of a single multi-state corporation among various state tax jurisdictions, nearly all states have adopted an apportionment formula approach in lieu of the separate accounting technique. Customarily, a three-factor formula of payroll, property, and sales is used to determine the amount of total net income attributable to a state. This formula approach divides the total income of the corporation by apportioning income according to the ratio of payroll, property, and sales within the taxing state to the taxpayer's total payroll, property, and sales. For example, if one-quarter of the factors are within a particular state, one-quarter of the total income of the enterprise is apportioned to that state for tax purposes.

In order for this system of formulary apportionment to work, all taxing authorities must agree on a uniform formula. However, the states have been unable to agree on a formula. For example, some states use one or two factor formulas. And, of those states that do use three factor formulas, the factors are not uniformlly measured, nor do all the formulas have equally weighted factors. In fact, some states have altered existing formulas which tend to increase receipts at the expense of out-of-state businesses.

S. 983 would prevent the states from continuing these attempts to erect mini-trade barriers and export their tax burden. The legislation sets forth a uniform equally weighted three factor formula as a ceiling to formulary apportionment. The need for such a system is highlighted by the recent U.S. Supreme Court decisions in the Mobil v. Vermont and Exxon v. Wisconsin cases. In each of these cases, the Court has moved further into the realm of encouraging formulary apportionment. As more income is subject to division by formula, the more important it is to have uniformity in apportionment formulas.

Unitary Accounting

A few states have expanded the formula apportionment method by adopting the so-called "unitary method" of accounting. Under this method, the apportionment formula is applied not only to the income of the specific corporation operating within the state, but the formula is also applied to the income of related corporations where those related corporations are part of a "unitary" group. Related corporations may include parent, subsidiary, or brother-sister corporations. A unitary group may be present if the related corporations are dependent upon or contribute to the business of the corporation within the taxing state. If a unitary group is found, the entities may be combined, i.e., their incomes and expenses may be aggregated for tax purposes after eliminating transactions between the group's members. Historically, the mere existence of common ownership or control of a related corporation has not been enough to establish the required unitary relationship. There must be a single stream of business which links the related corporations together. In fact, under the unitary concept the income and expenses of a single corporation which carries on more than one distinct line of business cannot be aggregated. The distinct lines of business are to be treated as independent businesses and reported separately for tax purposes.

S. 983 recognizes the unitary concept and sets forth a uniform definition of what entities can be combined. Again, uniformity is crucial so that states may not use combination based on whether revenue is raised. In recent years, a handful of states, principally California and Oregon, have extended the unitary method to the worldwide operations of in-state taxpayers and their related corporations. Under worldwide combination, the worldwide income of a unitary group of companies is added together, i.e., combined. That combined income is then apportioned to a state via the state's apportionment formula. Since worldwide operations are involved, the unitary group will usually include foreign as well as U.S. corporations.

Income from Foreign Sources

I. Scope of State and Federal Taxing Power

A major question before this Subcommittee is the extent to which a state or political subdivision may tax income from sources outside the United States. Fundamental to this inquiry is an understanding of the basic differences between the power of the federal government to tax the worldwide income of its citizens and the much more narrowly drawn power of the states.

Unlike a number of industrialized nations, the United States has deemed it appropriate to tax the worldwide income of its citizens. In order to avoid international multiple taxation of foreign source income, the Internal Revenue Code gives a dollar for dollar credit for those foreign income taxes paid in the country where that income is earned. Generally, the income of foreign subsidiaries of American companies is not taxed by the United States until that income is repatriated, i.e., paid to the U.S. parent via a dividend or otherwise. When repatriated, the foreign income tax paid by the foreign subsidiary may qualify for the Section 902 "deemed paid" foreign tax credit, again to avoid international multiple taxation.

On the other hand, the states do not have the power to tax the worldwide income of their citizens or persons doing business within their borders. Rather, there must be some definite link between a state and the income sought to be taxed. In looking at this required link, the U.S. Supreme Court has posed the question of whether the state has given anything for which it can ask a tax in return. States, while permitted to tax income from foreign sources, are not permitted to tax true foreign source income. As put by Justice Stevens in his dissenting opinion in the recent Mobil v. Vermont case, "It is fundamental that a State has no power to impose a tax on income earned outside of the State." Nevertheless, some states do tax dividends paid from foreign sources on the theory that the dividend was "earned" through activities within the state. In any event, for the purpose of worldwide combination, the question is not whether the state may tax the income of a local company earned abroad, but whether the state can calculate its tax based on the currently earned and unrepatriated income of foreign corporations.

II. Worldwide Combination And Distortion Of Income

(A) Apportionment factors tend to shift income to the taxing state.

The basic assumption of any formulary apportionment mechanism is that a certain amount of payroll, property, and sales will yield an equal amount of income wherever those factors are located. A good case can be made for this proposition inside the United States where the cost of labor, the cost of property, and the dollar value of a sale will not vary greatly from one state to another. However, this basic assumption is inherently incorrect if foreign operations are included as part of the unitary group.

Although not uniformly the case, wage rates tend to be higher in the U.S. than those rates paid abroad. The wage rate directly affects the payroll factor of the apportionment formula. Similarly, property values, which make up the property factor, tend to be higher here than outside the U.S. Whenever either of these results occur, there is a corresponding distortion in the allocation of the current income of the worldwide operation. Income is shifted from the place it was earned to the state using the apportionment formula.

This distortion might be better illustrated in the following example. Consider two unrelated manufacturers, one in California and one in Mexico. They both make cheese and both had separately calculated income of $100 last year. The California firm paid $500 in wages, held property worth $500, and had sales of $1000. The Mexican firm paid $200 in wages, held property worth $200 and had sales of $700. Assume for a moment that the California firm bought the Mexican firm and the firms were found to form a unitary group subject to worldwide combination. Instead of $100 of income apportioned to each country, twice as much income would be apportioned to California as would be apportioned to Mexico. This result flows directly from the distortion inherent in the payroll, property, and sales factors. In a similar vein, consider the situation of a unitary business which by any traditional accounting standard shows a loss for all operations in California and every other state. However, if the worldwide affiliates of the U.S. firm show a larger income than the U.S. loss, then the business would, in effect, pay state income tax on its loss operation in California.

(B) Worldwide combination fails to adjust for risk and other factors associated with investing abroad.

In previous examples, the very mathematics of the system will distort the allocation of income. However, there is another and more subtle distorting phenomenon. Keeping in mind that the basis of worldwide combination is that the same allocation of payroll, property, and sales will yield an equal amount of income wherever situated, the system is necessarily deficient because it fails to include a mechanism to adjust for risk and other factors associated with investing abroad. Common sense dictates that a company might demand a higher rate of return on its investment in countries such as Iran, Lebanon, or Nicaragua. And, only a few years ago each of these countries were considered stable and commercially attractive nations. In light of the everpresent threat of political instability, not to mention the bias against foreign investment resulting from the denial of the investment tax credit and accelerated depreciation, U.S. investment in the less developed world will by its nature require a higher rate of return on the same dollar of payroll, property, and sales.

(C) Worldwide combination results in extraterritorial taxation and international double taxation.

The worldwide combination approach is not an accurate measure of income, nor is it an acceptable substitute for the arms-length standard found in federal law. The crux of the matter was put succinctly by the late Laurence N. Woodworth in his testimony before the Senate Foreign Relations Committee on the U.S.-U.K. Tax Treaty where he stated:

> "Moreover, the unitary apportionment system as a means for determining the state taxation base of a multinational corporation is highly imperfect and a poor substitute for the arm's-length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation. (emphasis added)

The defenders of worldwide combination argue that the method is only a device whereby an accurate measure of the income generated from activities within the state can be gleaned. Worldwide combination's detractors claim that the distortionary effects of the system result in the states' anticipatory taxation of foreign source income. Relevant to this question is the following from George Carlson's article, "State Taxation of Corporate Income from Foreign Sources" from the Treasury's Essays In International Taxation: 1976:

> "Assuming that the unitary system is a device to measure income and not a device to tax foreign income, prohibition of the unitary system should involve little or no revenue change. However, California tax authorities have suggested that State tax revenues would decline by $125 million without the unitary system. The basis of this estimate is unknown."

The matter is put somewhat less delicately in a footnote which states:

> "According to California tax authorities, the worldwide application of the unitary system produces about $125 million in state tax revenue. The basis of this estimate is unknown, and the estimate itself appears to conflict with the California claim that the purpose of the unitary system is to measure California income, and not to tax foreign source income as defined for Federal tax purposes."

There is, of course, something amiss in this result. Again, from Laurence Woodworth's testimony before the Senate Foreign Relations Committee on the U.S.-U.K. Tax Treaty:

"If, in fact, there is a substantial revenue loss when an arms-length standard replaces unitary apportionment, this may be an indication that unitary apportionment does, in fact, result in unjustifiable extra-territorial taxation."

III. Worldwide Combination And Complexity

A seductive but illusory characteristic of worldwide combination is its apparent simplicity. Under the system there is no need for the sometimes complex adjustments needed for the sourcing of income (as in section 861 of the Internal Revenue Code) or the adjustment of income or expense (as in section 482). All that need be done is tally up worldwide income, payroll, property, and sales and the complicated matter is quickly put to rest.

Unfortunately, the matter is not that simple.

(A) Problems in determining the unitary group

The first hurdle that must be met is the question of whether the operations in, for example, California are part of a unitary business. The answer to this question must be derived from an enormous number of facts from all aspects of the operations of the related group. Since each member of a related group may have more than one distinct line of business, and consequently may be unitary only in part with the related group members, the number and type of combinations rise astronomically with the addition of new candidates for combination.

Complicating the problems of combination is the lack of a clear and understandable objective standard for a unitary group. In the final analysis, the determination of the existence and extent of a unitary group will be based on either the subjective opinion of an auditor or the decision of a court made years after the transactions at issue. The presence or absence of a unitary business can be the closest of questions, but can have tax and administrative consequences of an enormous magnitude. While these matters can pose problems across state lines, the extension of the unitary concept across international borders is unjustified. The addition of foreign members to a unitary group only adds new layers of complexity in the areas of language, currency translation, tax practice, and methods of doing business. All of these considerations make the problem of determining the existence of a worldwide unitary group essentially unmanageable.

(B) Problems in determining taxable income

The next set of problems created by the expansion of the unitary concept to worldwide operations are those associated with the measurement of the income base to which the apportionment formula is applied. Two principal problem areas are currency translation and tax practice.

Perhaps the more obvious source of difficulties in the measurement of income comes from currency translation. We are now in an era of generally free-floating foreign exchange rates. However, the income and expenses of each member of a unitary group must at some point be translated into U.S. dollars for the purposes of worldwide combination. It is not clear when or how the foreign exchange rate must be calculated. Is it done at the time of each income and expense transaction in question? At the end of the year? At the end of the accounting period? Is it an average of rates over a year? A weighted average? What sources are acceptable for this information?

Beyond these problems, there are transactions between members of a unitary group that may result in illusory gain or losses which would not "wash out" in the combination calculation because of differences in local accounting techniques. Losses could become gains and vice versa. Further, widely fluctuating currency exchange rates may dramatically alter the real income of accrual basis taxpayers and can change ventures profitable on paper into serious losses.

The second major problem in the measurement of income comes from the differences in accounting and tax practice from one country to another. For example, in order to reach net income all tax systems allow a taxpayer to deduct from income an amount representing a capital consumption or capital recovery allowance of some kind, but there the similarity ends. Some nations expense capital items, some use useful life depreciation, others use complex adjustments and accelerated techniques. Each yields a different net income.

Corporations subject to worldwide combination in California are required to resolve these differences in net income by filing a return which recalculates income in accordance with the provision of California law. However, when the State of California issues a proposed deficiency of tax, the Franchise Tax Board does not attempt to determine income in accordance with California standards, but rather income is estimated under the financial accounting standards that prevail in the relevant foreign jurisdiction. This is like the Internal Revenue Service issuing a proposed deficiency on the basis of a company's annual report instead of its properly filed and computed corporate tax return.

The reason why California does not recompute income under California standards when issuing a proposed deficiency of tax is that the task would be virtually impossible. To reach the California concept of income, all the property in use in the entire unitary group would have to be identified, including that property already written off according to the host country's accounting practices. Original cost would have to be reconstructed, a useful life assigned, salvage value determined, eligibility for accelerated methods examined, etc.

C) Problems with obtaining required information

As noted, in order to reach the net income of the unitary group, the entire group's income and expenses must be examined under the relevant state's standards. However, significant portions of the information may not be available to the U.S. taxpayer. While there are a number of reasons why this might be true, the clearest illustration of the problem is found in connection with a U.K. law which prohibits a U.K. taxpayer from releasing tax information relating to expenses incurred on U.K. defense work. One can easily see the plight of a U.S. aerospace company which needs precise income and expense information from its U.K. subsidiary. If that U.K. company does defense work, the information may be unavailable to the U.S. firm.

Worldwide Combination Precludes Uniformity

Throughout the foregoing discussion, I have continued to allude to the increased administrative costs imposed by worldwide combination. Although the seperate accounting system is not perfect and not without complexity, it is the accepted accounting standard for international operations. As a result, books, records, and most tax returns will continue to be under separate accounting standards no matter what the states do.

The fact that states may require other accounting methods from multinational companies is disturbing. No company relishes the prospect of setting up what amounts to a new tax accounting and tax planning operation for each state that now imposes worldwide combination, or might impose it in the future.

Foreign Source Dividends

We believe that the federal method should prevail in all U.S.-foreign tax matters. The injection of parochial state issues in international dealings between the U.S. and foreign governments should be avoided. The federal method of taxation (including the concepts of separate accounting, "deferral" and the foreign tax credit) has been designed to further the economic policies of the U.S. A key element of those policies is the free flow of capital and technology throughout the world. Unfortunately, the expansion of the unitary theory into international operations can only have a chilling effect on that free flow.

S. 983 and S. 1688 differ in the way that they solve the problems associated with worldwide combination. S. 983 prohibits the states from including foreign source income in the tax base. S. 1688 on the other hand, prohibits the use of worldwide combination and imposes a federal-type ceiling on the state taxation of foreign source dividends. The bill does not, however, exempt foreign source dividends from tax.

Of the two methods, we feel that S. 983 achieves the proper result. The relationship between activity within a state and income from foreign sources is tenuous at best. In light of the overriding federal interest in removing artificial barriers to international trade and investment, the states ought to be prohibited from taxing income from foreign sources. Of course, states should not be precluded from making section 482-type adjustments so that returns properly reflect income which may have been misstated due to less than arms-length transactions. However, the wholesale taxation of foreign source dividends is not an acceptable substitute for section 482-type adjustments.

As a compromise proposal, however, we would support S.1688 as a legislative resolution of the foreign dividend issue. The legislation would prohibit worldwide combination, but would impose a federal-type limit on the extent of state taxation of foreign source dividends.

The dividend portion of S. 1688 is particularly important in light of the recent U.S. Supreme Court case of Mobil v. Vermont. That case may tend to encourage states to make wider use of their power to tax foreign source dividends. However, not decided by the Court in Mobil is the appropriate formula for the apportionment of these dividends. At a minimum, a likely requirement will be the inclusion of the foreign payroll, property, and sales factors which gave rise to the dividend income. Clearly, that portion of the foreign income attributable to the foreign factors should be exempt from state tax. However, in order to achieve this result, the system would be forced to inject all the administrative and compliance problems of worldwide combination into the taxation of dividends. Consequently, a problem that had been limited to California and a few other states would then be expanded nationwide.

S. 1688 achieves a middle ground. Notably, it does not affect the taxation of foreign rents, royalties, technical fees, etc. Further, it gives the states two bites at the foreign income apple. First, it allows the continued use of section 482-type adjustments so that the total income is properly stated at the time the income is earned (all that should be necessary). And second, the legislation allows through its exclusion fraction state taxation of that portion of the dividend that the federal government effectively taxes after the allowance of the foreign tax credit.

The federal government has established a well defined and well understood method for taxing U.S. corporations with foreign subsidiaries and foreign corporations with U.S. subsidiaries. To the extent that states are permitted to tax income from foreign sources, they should be permitted to tax that income only at the time and to the extent the federal government taxes the income.

Under S. 1688, states would be prohibited from using worldwide combination. Further, they would be allowed to tax income from foreign sources consistent with the due process clause of the U.S. Constitution. The bill allows states to fully tax income from foreign sources when and to the extent that the U.S. taxes that income.

Since the foreign income subject to tax does not receive a foreign tax credit from the states for state tax purposes, foreign dividends might be the target of discriminatory or excessive taxation. S. 1688 prevents that result and applies a federal standard to income derived from foreign commerce, clearly an appropriate goal.

Conclusion

The time for federal legislation in the area of state and local taxation is long overdue. The present set of complex and often conflicting rules concerning state and local taxation of interstate commerce is a major obstacle to the proper functioning of our economy.

Compliance is burdensome for all firms, but nearly impossible for those businesses wishing to expand beyond their home state into interstate and international commerce. The lack of uniform rules is enticing many taxing jurisdictions to erect mini-trade barriers by shifting the tax burden to out-of-state firms. Setting uniform guidelines for taxing interstate commerce would reduce the risks and confusion of present law without violating the states' rights to tax activities within their borders.

S.983 TITLE I Sales & Use Taxes; Explanation of Major Provisions

§101 Uniform Jurisdictional Standards

This section codifies existing constitutional limitations on the taxing power of the states. Under the provision, States would have the power to impose a sales or use tax (or the obligation to collect such tax) only after a sufficient connection or nexus between the state and the taxpayer was demonstrated. If a taxpayer has a business location in the state (see §157), regularly solicits orders in the state, or regularly engages in household deliveries in the state, the taxpayer would be subject to the state's taxing power. Under §101(b), the same jurisdictional standard would be applicable to political subdivisions of a state.

Fair and uniform treatment of freight charges on interstate sales would result from §101(c) by excluding from the sales tax calculation any separately stated freight charge.

§102 Reduction of Multiple Taxation

Since states differ in their definition of where an interstate sale takes place, a uniform rule would be established by this section to reduce the risk of multiple taxation of the same transaction. Under the section, a sales or use tax could be imposed only on sales with a destination in the state. The term "destination" is defined in §155 and conforms to that found in the Uniform Division of Income for Tax Purposes Act. Political subdivisions would be subjected to a similar standard.

In certain instances, however, a state other than the destination may impose the tax or duty of collection. Cooperative agreements among states for the collection of tax would be expressly approved under §101(b), provided the taxpayer has a business location in the taxing state. For example, New Jersey and New York might agree that each would impose a collection obligation on their domiciliary sellers for sales with a destination in the other.

Small businesses would benefit from §102(c), designed to relieve the undue administrative burden of collection and compliance with respect to small returns. Sellers without a business location in the state and less than $20,000 per year in annual sales in the State would be exempt from the duties of collection. Under such circumstances, elimination of the administrative burden of collection and compliance far outweigh any de minimus revenue loss to the States. Nothing in §102(c) would prevent a state from collecting the tax from the in-state purchaser and nothing in the section would relieve the seller from the obligation to remit any tax actually collected.

§103 Sales to Registered Business Purchaser; Exempt Sales

Under this section, a seller would be relieved of tax liability if the buyer certifies that the sale or the seller is exempt from tax. The seller's liability is not relieved, however, if at the time of receipt of the written evidence, the seller has actual knowledge that the evidence is false or inaccurate.

§104 Sales by Certain Out-of-State Sellers

Under §104 a procedure would be established whereby out-of-state sellers (see §156) with less than $100,000 of taxable sales in a state could elect to have the buyer certify the rate or amount of tax applicable to the transaction. The certification must be signed by the buyer and must set forth the buyer's name, address, and tax registration number, if any.

Nothing in the section would limit a seller's liability if at the time of receipt the seller has actual knowledge that the buyer's certification is false or inaccurate.

The failure of a buyer to certify the rate would be handled under §104(b). In such instances, the seller would collect and remit the maximum combined State and local taxes applicable in the state.

The Secretary of Commerce would be directed by §104(e) to prescribe a standard form of return for sellers electing the buyer certification procedure. If the standard form incorporates all information required for all states, the seller could file a certified copy of the standard form in lieu of separate return for each state.

§105 Accounting for Local Taxes

While the 51 taxing jurisdictions of the states and the District of Columbia provide a complexity and difficulty for all interstate taxpayers, the thousands of local taxing jurisdictions present an even more vexing problem. Under §105, sellers need not classify sales according to subdivision of a state except with respect to those subdivisions in which the seller has a business location or regularly makes household deliveries.

§106 Savings Provisions

This section preserves the rights of the states to proceed against purchasers for taxes due, except in instances where the seller has collected but failed to remit the tax.

§107 Liability with Respect to Unassessed Taxes

For periods ending on or before the enactment of the bill, no assessments could be made for sales or use taxes if during that period the seller did not maintain a business location, solicit orders through employees, or regular engage in deliveries in the state.

STATEMENT

BY: William C. McCamant
Vice Chairman of the Board
National Association of
Wholesaler-Distributors

BEFORE: Subcommittee on Taxation and
Debt Management Generally
Senate Finance Committee
United States Senate
Washington, D.C.

SUBJECT: S.983, The Interstate Taxation
Act of 1979

DATE: June 24, 1980

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NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
1725 K Street, N.W. • Washington, D.C. 20006 • 202/872-0885

STATEMENT BY WILLIAM C. MC CAMANT ON BEHALF OF THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS BEFORE THE SENATE AND FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

My name is William C. McCamant. I am the Vice Chairman of the Board of the National Association of Wholesaler-Distributors, 1725 K Street, N. W., Washington, D. C. I appreciate having the opportunity to appear before the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee today in behalf of the members of the National Association of Wholesaler-Distributors, and offer testimony as to the immediate need for Federal legislation to govern State sales and use tax on interstate sales.

The Wholesale Distribution Industry

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nuture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit, and other critical services.

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small-to-medium sized, closely held, family-owned businesses. Of the 215,000 merchant wholesaler-distributor corporations filing tax returns in 1973, 98.7% had assets of less than $10 million. These smaller firms accounted for about 65% of the industry's sales volume.

The recent Census of Wholesale Trade, which was conducted by the Bureau of the Census in 1973 for the year 1972, reported that approximately 75 percent of the wholesaler-distributor business establishments had annual sales of less than one million dollars and that about 85 percent had sales of less than two million dollars. In over three-quarters of the establishments, the average employment was probably between six and ten people; in less than 15 percent of the establishments were there likely to be more than 25 employees.

By contrast, in the manufacturing sector approximately

2% of the firms, controlled about 88% of the assets and accounted for approximatelye 80% of sales.

Industry sales totaled approximately $883 billion in 1979 and are expected to reach $998 billion in 1980, according to Commerce Department estimates.

NAW

The National Association of Wholesaler-Distributors ("NAW") is a federation of 115 national wholesaler-distributor associations, which have an aggregate membership of approxmately 43,000 wholesaler-distributors, with 125,000 places of business. The members of our constituent associations are responsible for 60% of the $998 billion of merchandise which will flow through wholesale channels this year. They employ a comparable percentabe, or 2.5 million, of the 4 million Americans who work in wholesale trade. Although the individual firms which our organization represents are small-to-medium size businesses individually, their collective economic importance is most significant. A full listing of the national associations affiliated with NAW is contained in Appendix I.

Impact Of Sales And Use Tax On Interstate Sales

The approximately 200 major wholesale market centers of this nation do not respect state and local subdivision boundaries. Hardly a single one is wholly contained within the boundaries of one state - - much less within local subdivision boundaries - - and most markets cover several states. The multiplicity of sales and use taxes now being levied on interstate business transactions by the States and by thousands of cities, counties, school districts, police jurisdictions and other local taxing jurisdictions has wrought utter havoc and chaos in the small business organizations trying to engage in interstate commerce. In 1964, sales and use taxes were levied by approximately 2,300 State and local units. This figure has now more than doubled to 6,250 and the number is steadily growing, creating a system of taxation which chokes the free flow of commerce among the States.

Sales and use taxes imposed by State and local governments have been the subject of very extensive Congressional hearings going as far back as 1962. Hundreds of witnesses representing the business community, revenue authorities of the various states, tax and legal scholars, presented extensive information. In addition, the general problem of the extension of State legal jurisdiction to impose tax and the authority and responsibility of the Federal government to define the State authority were thoroughly reviewed.

In the 90th Congress the House passed H.R. 2158 by a vote of 284 to 189. H.R. 2158 set forth what we believe to be fair and effective jurisdictional standards regarding the authority of a State to collect sales and use tax from an out-of-state seller on sales in the State. Then in the 91st Congress a similar bill, H.R. 7906, was again passed by the House of Representatives by an overwhelming margin of four to one.

In the 93rd Congress the Senate Finance Committee created a Subcommittee on Interstate Taxation to hold hearings on this serious problem and to take the necessary action. Unfortunately the press of other business prevented the Finance Committee from taking action as a result of the hearings held by Senator Mondale.

In 1977, Senator Mathias introduced S.2173 in the 95th Congress, a bill which generally followed the provisions of the previous House-passed bills. Extensive hearings were held on the bill by Senator Mathias in Biloxi, Mississippi; Charleston, South Carolina; Columbus, Ohio; and San Francisco, California, with dozens of businesses and other witnesses testifying as to the critical need for simplicity, uniformity and fairness in the area of interstate taxation, and to restore efficiency which has been the hallmark of our American economy.

Now the Subcommittee has before it for consideration S.983, The Interstate Taxation Act of 1979, sponsored by Senator Mathias. NAW is pleased to once again offer testimony on the severe problem small businesses - - our constituency - - are having in the area of sales and use tax on interstate sales.

We are not concerned about taxes *per se*. What we are concerned with here is the definition of a State; with how far a State can reach beyond its borders in order to require a non-resident business to take a certain action, which in this case pertains to the collection of sales and use taxes. We are not asking this Subcommittee or Congress to review the tax laws of 50 States; rather we are asking Congress to settle a boundary dispute - - where should the interstate line be drawn in a business transaction?

There is a need for Congress to serve as Mason and Dixon served many years ago to settle the geographic boundary between Maryland and Pennsylvania. There is a need for a similar determination of the boundary between two States on business transactions with regard to the imposition of a sales or use tax. Somewhere in the business transaction the authority of one State ends and the authority of another State begins. Maryland and Pennsylvania cannot without great local confusion and unfairness over-lap their boundaries on business transactions without impeding the flow of commerce between the States, creating many problems for those who wish to comply with the laws governing commercial transactions. This is true not only for sales and use taxes, but also for income and gross receipt taxes.

Federal Action Required On The Problem Of Interstate Taxation

The question we must all face here today is: "What federally mandated solution will be best for the States and the business community?" It is obvious from the results of the State efforts of the past decade that they cannot and will not come to a solution - - neither a compact nor a uniform tax act. This is nowhere more evident than in the disappointing experience of the Multistate Tax Commission, organized in 1967 for the admitted purpose of making Federal interstate taxation legislation unnecessary. Only a handful of States are now members, mostly

States west of the Missippi River. Four States that belonged to the Commission - - Indiana, Illinois, Florida and Wyoming - - have withdrawn. Moreover, the Commission has been preoccupied with corporate income tax matters. No voluntary effort among the States will solve the severe problem now facing smaller business enterprises which do not have the financial resources to defend themselves in the shadowy area of tax liability on interstate taxation.

We wholesaler-distributors have felt for years that the legislation, as twice passed by the House, is an equitable solution for the sales and use tax area. We do not believe that its enactment would result in any loss of revenue to the States and subdivisions. In an effort to be cooperative and try to reach a fair solution, we have conferred with many State tax administrators, economists and others interested in a solution.

The business community was not then and is not now in favor of any federal legislation that will bring about the loss of millions of dollars of revenues to the States and their subdivisions. After all, we are all citizens of the States and local communities that must have the revenues to give us the essential services that we all require.

Dr. Benjamin Franklin wrote: "Our Constitution is in actual operation; everything appears to promise that it will last; but in this world nothing is certain but death and taxes."

Businesses are not so certain as to their obligations and duties on interstate tax transactions as Dr. Franklin believed. There is a large gray area that sound tax principles would indicate needs to be resolved. Certainty is a requisite to effective tax law: certainty as to jurisdiction; certainty as to what the tax is; certainty as to who must comply; and with these, some reasonable methods and procedures for the revenue authority to collect the tax effectively.

It is estimated that compliance with State sales and use tax by out-of-state sellers is as low as 10 percent. It is the utter lack of certainty and the tremendous complexity of State law that has created this situation. Uniform and fair jurisdictional standards and simplified procedures enacted at the Federal level would create the certainty and remove the unnecessary complexity which breeds such low compliance. Accordingly, we are not petitioning you to provide tax exemption to a broad group of present taxpayers in the sales and use tax area.

NAW's members typically sell 50 percent of this total volume to retailers for resale. The other 50 percent is sold to industrial, commercial, service and contractor buyers who may either resell the product or use it in the performance of their trade or business. Only the in-state buyer really knows what is to be done with the goods. In all cases where a resale exemption number is furnished to an out-of-state vendor, the mere existence of the number in his files should be sufficient evidence of compliance, and the tax collector should be required to look to the in-state buyer for the tax due, if any.

We note that S.983 goes a long way toward achieving this result in Section 103, which precludes sales or use tax liability being imposed on an out-of-state seller who obtains a written certificate that the sale is for resale or otherwise exempt from sales and use taxation, absent actual knowledge at the time of receipt that the certificate is false or inaccurate.

We note also that S.983 has many of the provisions required to deal with the complex problem of sales and use tax in interstate sales transactions. It is our belief, however, that the most critical provision is one that sets forth clear, concise and uniform jurisdictional standards to limit the power of a State or its political subdivision to require an out-of-state seller to collect a sales or use tax on sales in that State. This power to tax should be limited to sellers with a business location* in the State (or political subdivision), or sellers making household deliveries in the State (or political subdivision), other than by U.S. Mail or common carrier. These are the same standards advanced in the prior legislation, including the two bills passed by the House of Representatives in the past. These standards protect business selling in interstate commerce but also protect the interest of the States in collecting the taxes to which they are entitled.

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*A person has a business location within the State if the person owns or leases real property within that State, or has one or more employees located in that State, or regularly maintained a stock of tangible personal property in that State for sale in the ordinary course of business.

Conclusion

NAW believes Congress has given the States more than an adequate amount of time to work out a solution among themselves to the problem of sales and use taxation on interstate sales. It is also our considered opinion that it is impossible to obtain a compact among the 50 States in this area, or even to obtain any degree of uniformity without Federal legislation. Further reliance on a State-level solution would be misplaced. We agree totally with Senator Mathias who issued a warning when introducing the Interstate Taxation Act of 1979:

> "We cannot wait any longer for reform. We must act now. For too long, the debate has been bogged down in the technical language of experts. We have passively adopted their terms of reference and conducted the debate at the wrong level. We must raise the level of debate and talk frankly about the larger issues - - about jobs, the national interest and economic survival." (Cong.Rec., Vol. 125, No. 47, April 23, 1979)

Now is the time to act.

June 24, 1980

APPENDIX I

National Wholesaler-Distributor Organizations
Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Cooperative Food Distributors of America
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Fireplace Institute
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Foodservice Organization of Distributors

General Merchandise Distributors Council

Hobby Industry Association

The Irrigation Association

Laundry & Cleaners Allied Trades Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America - Wholesale Div.
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Wholesalers
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Ceramic Association, Inc.
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Notion Wholesaler Distributor Assn., Inc.
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Waste Management Association
National & Southern Industrial Distributors Associations
National Swimming Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association

Pet Industry Distributors Association
Plastercraft Association
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute

Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Wholesalers Association
Warehouse Distributors Association for
Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wine & Spirits Wholesalers of America, Inc.
Woodworking Machinery Distributors Association

SUMMARY OF MR. WEBSTER'S TESTIMONY
BEFORE THE SENATE FINANCE COMMITTEE
JUNE 24, 1980

Mr. Chairman, my name is George D. Webster, and I am an attorney in Washington, D.C. with the law firm of Webster and Chamberlain. I am accompanied by G. Stewart Boswell, Director of Government Relations for AAMA, and Michael Rigas, also a lawyer with Webster and Chamberlain. I am here today on behalf of AAMA and the Haggar Company of Dallas, Texas, to urge passage of S. 983, the Interstate Taxation Act of 1979. I hope that my remarks will assist you in your efforts to gain Senate approval of this important piece of legislation.

At present, there are few restrictions on the rights of states to tax interstate businesses. One Supreme Court decision allows a state to impose a gross receipts tax on businesses that employ only one person in the state, and that person need not even solicit orders or have an office outside his home. Another decision permits a state to require businesses to collect use taxes even though all orders are solicited through independent sales contract people.

States also are given great leeway in assessing net corporate income taxes. Although Public Law 86-272 exempts businesses whose sales representatives confine their activities to solicitation of orders, states have been steadily narrowing the scope of activity which is considered "soliciting orders" for taxation purposes. Moreover, states are permitted to use combined reporting in order to tax worldwide income of a company, even though such income bears no relationship to the amount of business activity within a state or the amount of services being provided to the company by the state.

The apparel industry considers the current state of affairs with regard to state taxation of interstate commerce to be chaotic, inequitable, and generally unsatisfactory. The lack of a consistent standard among the states as to which businesses can be taxed precludes effective long-range business planning. The heavy amount of paperwork required by the states interferes with industry efforts to keep prices at relatively low levels. The lack of a meaningful nexus requirement between the level of a firm's activity in a state and the state's right to tax that firm allows a state to impose taxes even when business activity within the state is at a bare minimum.

Haggar Company and AAMA believe that S. 983 will correct the abuses described above. It provides definite standards for determining what level of contact a business must have with a state before a use tax or gross receipts tax can be levied. It prevents a state from taxing a business that has only minimal contact with the state. It reduces the amount of paperwork to be done by firms and it eases the administrative burden on interstate businesses. Finally, it removes the worst feature of the net income tax, the right of states to tax the foreign income of a company. The optional three-factor formula in the bill is straightforward and easily interpreted; it will protect companies against excessive, irregular and indiscriminate state taxation of corporation income.

In conclusion, we support S. 983 and urge this committee to act favorably on it. Without such legislation, the American apparel maker will be hardpressed to compete in today's marketplace.

I will be happy to answer any questions you may have ...

STATEMENT OF GEORGE D. WEBSTER
TO THE SENATE FINANCE COMMITTEE
ON S. 983,
THE INTERSTATE TAXATION ACT OF 1979

WASHINGTON, D. C.
JUNE 24, 1980

Mr. Chairman, my name is George D. Webster, and I am an attorney in Washington, D. C. representing the American Apparel Manufacturers Association. I am accompanied by Mr. G. Stewart Boswell, Director of Government Relations for the Association.

I am here today on behalf of AAMA and a member company, the Haggar Compahy of Dallas, Texas, to urge the passage of S. 983, the Interstate Taxation Act of 1979.

Haggar Company is a privately-owned company principally engaged in the manufacture of men and women's apparel. AAMA is a national trade association which represents manufacturers of more than 60% of the wearing apparel made in the United States. AAMA has over 400 members, which range in size from the large publicly-held corporation to the very small family-owned business. The apparel industry is among the most competitive sectors of the economy, and it delivers high quality clothes for relatively low cost.

Legislation to regulate state taxation of interstate commerce is long overdue. I hope that my remarks today will assist you in your efforts to gain Senate approval of this important piece of legislation.

I will begin by giving you an idea of how businesses in the apparel industry sell their products. Typically, an apparel firm will employ a number of sales representatives, and will assign these representatives territories in which to solicit orders from retail customers. These sales representatives are generally paid on a commission basis, and their assigned territories often include several states. Even a very small company may sell its garments in 20 or 30 states through the efforts of its sales representatives.

Almost without exception, the sales representatives of apparel manufacturers confine their activity to the solicitation of orders which are sent to the home office for approval or rejection. Thus, as a general rule, sales representatives do not approve orders themselves, do not maintain an inventory of garments, and do not handle shipments of garments after orders are approved.

At present, there are few restrictions on the rights of states to tax interstate businesses. In the absence of federal legislation on the subject, the Supreme Court has steadily expanded the concept of what constitutes a sufficient nexus between an out-of-state vendor and the taxing state to allow the state to impose use taxes and gross receipts taxes.

In Standard Pressed Steel Company v. Department of Revenue, the Court permitted the State of Washington to collect a gross receipt tax from a business that employed only one person in the state--a person who did not solicit orders and whose only office was in his home. Scripto v. Carson held that a state could impose an obligation to collect use taxes even though all orders had been solicited through independent sales contract people.

States also have great leeway in assessing net corporate income taxes. Under Public Law 86-272, a manufacturer is not subject to a state's net income tax if his sales representative confines his activity to solicitation of orders. Unfortunately, in recent years, states have been narrowing the scope of activity which is considered "soliciting orders" and, therefore, protected from tax. Moreover, in Norman Manufacturing Company v. Blair, the Supreme Court upheld a method of apportioning income that uses combined reporting in order to tax world-wide income of a company. Such income bears no relationship to the amount of business activity of a company within a state or the amount of services being provided to the company by the state.

The current state of affairs demands reform. It imposes unfair burdens on apparel firms in several ways.

First, there is no uniformity among the states as to what level of business activity warrants taxation. Each state sets its own standards for determining which businesses can be taxed. This lack of uniformity precludes effective planning and increases the costs of conducting interstate business. The apparel industry wants to know with certainty what its tax liability will be in each state.

Second, the present system requires an inordinate amount of paperwork. Firms in the apparel industry cannot be expected to keep their prices at relatively low levels when they have to satisfy the different paper requirements of a variety of states.

Third, there is presently too little in the way of a nexus requirement between the level of a firm's activity in a state and the state's right to tax that firm. Too many apparel companies are taxed even though they have minimal contacts with the state involved. For example, the Haggar Company does not own or maintain any offices, inventory or other property outside of Texas, but it nevertheless has been taxed on its sales outside of Texas. In fact, West Virginia went so far as to assess the company five years back gross receipt taxes computed on an amount equal to about six times the company's actual sales volume in the state, even though Haggar's West Virginia staff consisted of only two resident salesmen who solicited orders that were approved and filled in Dallas. Examples such as this point out the need for quick legislative action.

Haggar Company and AAMA believe that S. 983 will correct most of the abuses described above. It provides definite standards for determining what level of contact a business must have with a state before use taxes or gross receipt taxes can be levied. These standards are not so minimal as to let the states do whatever they want. The definitions of "business location", "location of employee", and "business office", in particular, insure that a company will not be taxed unless genuinely conducting business in a state. Other provisions relieve the tax burden on interstate businesses by exempting separate freight charges from the use tax and by reducing the degree of multiple taxation.

The bill will also reduce the amount of paperwork required by states and ease the administrative burden on interstate businesses. Section 104, for instance, allows an out-of-state seller with less than $100,000 annually in taxable sales to acquire a certification from the purchaser as to the correct rate or amount applicable to the sale; it also provides for a standard form of return. Likewise, the exemptions of Sections 102c and 105 will help lessen the apparel industry's administrative load.

Title 3 of S. 983 removes the worst feature of the net income tax, the right of states to tax the foreign income of a company. Moreover, the optional three-factor formula incorporated in the bill is straightforward and easily interpreted and will protect companies against excessive, irregular and indiscriminate state taxation.

S. 983 will not unduly restrict state taxing activities. It leaves to the states full authority to impose a use tax on the sale of vehicles, boats and motor fuels and, in Sections 106 and 202, it sets forth state taxing prerogatives not to be affected by the rest of the bill.

In conclusion, we support S. 983 and urge this committee to act favorably on it. Without such legislation, the apparel maker will be hard pressed to compete in today's marketplace. In addition to the taxes themselves, the task of preparing and filing tax returns in 20 or 30 states can be very costly, and may simply be too much for the small manufacturer. We therefore urge your Committee to approve this legislation, and hope that the Senate and House will enact it into law.

I will be happy to answer any questions you may have.

Statement of

J. M. Haggar, Founder

The Haggar Company

Dallas, Texas

Mr. Haggar is unable to appear, but asked that the following statement on his behalf be included in the record of hearing on S. 983.

"We are paying state taxes in the state of Washington and the state of West Virginia, which we previously had refused to pay because we thought they were unconstitutional. However, they tied up our accounts receivable and forced us to pay these taxes, which we are still doing. In checking with a lot of our competitors that have the same merchandise and the same kind of business, we were told that they do not pay these taxes. When we asked the states about this, they replied, 'they will pay the taxes when we catch them.' In my opinion, this is not the American way because it reflects inequities and unfairness.

"We do not mind assuming this financial responsibility as long as the taxes are charged to all businesses in the same equitable fashion. The chaotic way these taxes are assessed, it not only is unfair, but precludes effective long-range business planning.

"In my opinion, you and your committee should support bill S. 983 because it would appear that it is designed to correct a situation which goes against America's concept of fairness for all citizens and all businesses."

Senator **Byrd**. Next will be a panel of five, Mr. Arthur C. Roemer, president, National Association of Tax Administrators, and deputy commissioner of the Minnesota Department of Revenue; Mr. Benjamin F. Miller of the California Franchise Tax Board; Mr. Theodore W. deLooze, chief tax counsel, Oregon Department of Revenue; Mr. Eugene F. Corrigan, executive director, Multi-State Tax Commission; Mr. Jonathan Rowe, associate director, Citizens for Tax Justice.

Gentlemen, you may proceed, and determine among yourselves who will go first.

STATEMENT OF ARTHUR C. ROEMER, PRESIDENT, NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, AND DEPUTY COMMISSIONER OF THE MINNESOTA DEPARTMENT OF REVENUE

Mr. **Roemer**. Mr. Chairman, my name is Arthur C. Roemer. I am president of the National Association of Tax Administrators.

I have submitted a prepared statement which, with the chairman's permission, I would like to have incorporated into the record.

Senator **Byrd**. Without objection.

Mr. **Roemer**. The executive committee of the National Association of Tax Administrators, an organization of the State revenue departments of the 50 State governments and the District of Columbia, respectfully requests the Subcommittee on Taxation, and Debt Management of the Senate Finance Committee to take no action on S. 983 and S. 1688.

The NATA executive committee, as it always has, stands ready to assist Congress in developing solutions to problems in interstate taxation. Its objections to S. 983 and S. 1688 may be summarized as follows.

One, the bills would restrict State taxing authority, interfere with the long-standing division of Federal and State taxing power, establish a precedent for further adverse action against the States, and reduce State revenue.

Two, the bills would inflict these losses on the States without compensating them by correcting existing Federal restrictions on State taxation of interstate transactions which result in discrimination against local business and in the loss of revenue to State and local governments.

Three, the bills disregard the substantial uniformity the States have achieved in their income and sales taxation of interstate transactions. They would impose new restrictions on the States in areas of taxation where uniform provisions are prevalent, and where the courts have stated that multistate and multinational taxpayers have judicial protection against discriminatory treatment.

Most notably, the States have achieved uniformity or near uniformity in the following areas: Corporation income tax base; standard apportionment formula; credit for sales or use tax paid to another State; State collection of local sales taxes; exemption and resale certificates; discrimination against interstate transactions; charges for expense for out-of-State audits; and extended filing period.

Statistics concerning this uniformity are contained on pages 3 and 4 of the prepared statement.

Four, in their provisions relating to foreign source income, the bills would bar the use of the unitary method in taxing foreign source income, a method employed by some States. States point to the fact that the unitary method has long been upheld by the courts, and is regarded as a reasonable basis for apportioning corporate income.

In place of the unitary method, the bills would require the States to adopt the arm's-length method which has been subject to widespread criticism and would result in major compliance and auditing problems.

S. 983 and S. 1688 would impose important limitations on the States' ability to tax foreign source dividends. The NATA executive committee supports the position of the U.S. Treasury opposing the provisions of S. 1688 relating to State taxation of foreign source dividends.

Five, passage of the bills at this time, when a General Accounting Office study of State income taxation of multijurisdictional business authorized by Congress is in process, would negate the value that that study is intended to have.

Six, the bills conflict in a number of areas with the NATA policy statement on the taxation of interstate business, a set of principles adopted by the States in 1979. The principles in the NATA policy statement are designed to balance State and taxpayer concerns in the taxation of interstate and multinational income.

They reflect the willingness and desire of the State tax administrators to cooperate with Congress in solving State and taxpayer problems in interstate taxation in a form that would provide equity for both local and multistate taxpayers and permit the effective and equitable administration of State taxes.

In approving the NATA policy position, the State tax departments comprising NATA's membership stressed that it reflected compromises by all States, and is an integrated consensus of the States, and that if the statement were fragmented or balanced, it could no longer be represented as a collective position of the States.

In conclusion, for the reasons stated above, the executive committee of the National Association of Tax Administrators urges Congresss to take no action on S. 983 and S. 1688, and it reiterates its willingness and desire to discuss the issues involved with Congress.

Senator Byrd. At this point, the committee would like to depart from the regular order and recognize the Senator from Idaho, Mr. Church, who has other obligations.

Senator Church, the committee is very glad to have you. Would you prefer to make your statement now or would you prefer to wait until after the vote?

Senator Church. The vote is on, isn't it? Perhaps we had better vote together and come back. My statement would run longer, I think, than the time available before the vote.

Senator Byrd. If it is agreeable to Senator Packwood, the committee will stand in recess, and the three of us can vote, and we will come right back.

Senator Church. Thank you very much, Mr. Chairman

[Whereupon, a brief recess was taken.]

Senator **Byrd**. The committee will come to order.

The Senator from Idaho, Mr. Church, is recognized.

Senator **Church**. Thank you, Mr. Chairman.

Senator **Byrd**. We are very glad to have you, Senator Church.

STATEMENT OF HON. FRANK CHURCH, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator **Church**. I appreciate the opportunity to testify before the subcommittee on S. 1688 and S. 983. These two bills mandate sweeping changes in the formulas used by States to assess multinational corporate income tax liability. As someone who has long been concerned with the preservation of States' rights in fashioning their own tax rules, I am here today to express my firm opposition to the proposed legislation.

At a time when the Federal Government should be limiting its intrusion into the legitimate jurisdiction of the states, S. 983 and S. 1688 would accomplish the exact opposite. The States would be prohibited from using the unitary taxation method, and would also be restricted in taxing the dividends that a corporation receives from its foreign affiliates.

The effect of such legislation cannot be understated. It would usurp the traditional prerogatives of the States. It would enable multinational corporations, particularly the international oil companies, to evade tax payments of hundreds of millions of dollars. It would discriminate against small business, and against all American companies which choose to invest at home instead of abroad.

It would deprive the States of much-needed revenue approximating hundreds of millions of dollars. It might very well accelerate the purchase of American farmland by foreign investors. In short, at a time when our Nation is experiencing serious recessions, some might say bordering on depression, it makes absolutely no sense to punish the American farmer, consumer, and taxpayer for the benefit of the multinational corporations, which are the only ones who stand to reap additional profits under this legislation.

Federal Government should not be stripping away one of the fundamental powers still left to the States, that of State taxation.

In 1978, Mr. Chairman, I led the successful battle against the inclusion of article 9-4 in the United States-United Kingdom Tax Treaty, an article which attempted by treaty, as this bill now attempts to do by U.S. law, to deny the States their legitimate right to tax.

Two arguments were advocated by supporters of that article. One, that the States would not lose any revenue by dropping the unitary method, and two, that the inclusion of article 9-4 was necessary in order to secure ratification of the treaty by the British.

The evidence raised during that debate and the ratification of the treaty without article 9-4 by the British established a solid case for leaving State taxation to the States. At that time, tax authorities from over 25 States expressed their belief that any restriction imposed on the unitary method would seriously impair their ability to assess and collect the appropriate amount of corporate tax liability.

The evidence against these same restrictions on States' rights as they now appear in S. 983 and S. 1688 has been mounting ever since.

In March, the Supreme Court ruled against the Mobil Oil Corp. and upheld the right of Vermont to include in its tax base Mobil's dividend income from foreign affiliates and subsidiaries. The Court clearly rejected Mobil's argument that its subsidiaries and affiliates were somehow unrelated to the sale of petroleum products in Vermont.

Harriet King, commissioner of the Vermont Department of Taxes, has noted that:

> * * * had Mobil been able to exclude its dividend income from Vermont's apportionable tax base, it would have paid only $25 in Vermont taxes for 2 of the 3 years at issue, notwithstanding sales in the State for those 2 years totaling more than $18 million and Federal taxable income totaling approximately $528 million.

On June 10, the Supreme Court upheld the right of a State to base its corporate income tax using the very same unitary method that these bills now attempt to take away. In this suit, the Exxon Corp. contended that it should only be taxed on its marketing operations in Wisconsin, not on its refining, exploration, or production operations. Although it had huge profits, Exxon maintained that it owed nothing in taxes to Wisconsin for the 4 years from 1965 through 1968.

In fact, Exxon filed Wisconsin income tax returns showing losses for each year.

This case demonstrates how the oil companies manipulate their profits to avoid income tax liabilities. The legislation before this committee is premised on the ability to segregate profits—the very arguments that were deemed without merit by the Supreme Court. But no doubt the oil companies and other multinationals will continue to press for these bills.

In California alone, the revenue lost by passage of these bills would total over $485 million, of which the oil companies would be exempted from paying half that sum. In Idaho, the effect of these bills would be tantamount to cutting as much as $16 million, or 40 percent from the corporate taxes collected by the State. Half of that $16 million would be pocketed by the oil companies.

It is unfair, Mr. Chairman, to contemplate new tax loopholes for the oil companies when their profits have never been higher. A recent Wall Street Journal survey shows that 19 oil companies posted a 93-percent gain in profits for the first quarter of 1980 over 1979. Its survey of 543 major corporations, including the oil companies, showed a 17-percent increase, the average for the 543, in the first quarter of 1980 profits. But without inclusion of the oil giants, the earnings from all the other corporations would have registered a 1.7-percent decline from the year before.

As a result of oil decontrol, the oil companies stand to gain additional profits totaling hundreds of millions of dollars during the coming decade. Do the American people want these companies to be granted further tax loopholes?

In a State like mine, Mr. Chairman, I might point out that the loss of revenue will have to be made up by taxing small companies and property holders and the individual citizen, and they are already very heavily taxed.

Furthermore, we ought not to be exporting jobs and capital abroad when rising unemployment makes imperative that need for more investment in the United States. Yet the practical effect of the proposed legislation will be to grant new tax incentives that will only encourage the flight of U.S. corporate investment abroad.

These bills would impose a tax rate ceiling of 46 percent on a U.S. corporation's foreign subsidiaries; and once these corporations could demonstrate that the aggregate foreign taxes paid were equal to 46 percent, then the States would be prohibited from taxing the dividends these subsidiaries sent back to the U.S. corporation. Yet U.S. subsidiaries of American corporations would still be required to pay State and local taxes on their dividends on top of the U.S. Federal rate of 46 percent.

Thus, American companies would be encouraged to set up subsidiaries abroad or in foreign tax havens where the dividends will be immune from State taxation. I see no reason that an American corporation with only domestic operations should be forced to pay effectively a higher tax rate than ones with foreign operations. It legitimatizes discrimination, and it accelerates a dangerous trend that has already begun.

According to recently released Commerce Department projections, investment abroad by American companies will increase 26 percent this year, while investment in the United States will grow by only 11 percent, less than half as much.

The corporate income tax is one of the few ways with which oil consuming States like Idaho are able to recoup their fair share of the massive profits being drained out of their economies. Any cut in the corporate income taxing authority of the States can only be made by increasing the already heavy burden of income and property taxes on ordinary citizens, as I have already pointed out.

At a time of ravishing inflation, the enactment of any legislation that would cause a rise in taxes for the average citizen for the benefit of big business is simply unacceptable. The restrictions proposed in S. 983 and S. 1688 will render it almost impossible for State tax authorities to assess corporate tax liability in a fair and flexible way to meet changing conditions.

Under the rigid straitjacket imposed by these bills, corporations would be able to transfer their income in sales from one State into another for the sole purpose of minimizing tax liabilities.

The last point I would like to raise this morning concerns the effect of this legislation on the American farmer. I come from a State where the specter of foreign takeover of U.S. farmland is taken very seriously. This legislation would compound the serious loophole that already exists—the avoidance of capital gains tax on real estate sold by foreign investors. To the credit of Congress, Mr. Chairman, your committee has just approved legislation that would close this loophole.

It is my opinion, however, that S. 1688 and S. 983 would effectively neutralize that corrective legislation. As Rubin L. Johnson, director of legislative services of the National Farmers Union, noted in testimony before the House Ways and Means Committee on March 30, 1980, H.R. 5072, which is identical with S. 1688, poses a serious threat to American farmers, because it would subsidize foreign investment in U.S. farmland by sheltering the profits of foreign investors from effective State taxation.

I readily concede that the unitary method is not perfect, but this is the one proven method for controlling the ability of a corporation to switch income earned from one State or country to another which has lower tax rates or no income taxes at all.

All companies, including the oil companies and multinational corporations, should be asked only to pay their fair share of taxes. I do not think, however, we should legislate a scheme that enables them to pay less than their fair share.

Above all else, the issue before the committee is whether the Federal Government should be telling the States how to run their business. If we strip away the tax authority of the States, then we will make a mockery of the Federal-State system.

Over 200 years ago, our ancestors protested taxation without representation. We cannot allow the multinational companies through the Federal Government to restrict State taxation, for that would be representation without taxation, a concept inherently unfair to every ordinary American citizen.

Thank you, Mr. Chairman. That concludes my statement.

Senator BYRD. Thank you, Senator Church.

At this point, I will insert in the record a letter from the Department of Revenue and Taxation of the State of Idaho, such letter being signed by Jenkin L. Palmer, chairman, Idaho State Tax Commission.

[The material referred to follows:]

DEPARTMENT OF REVENUE AND TAXATION,
STATE TAX COMMISSION,
Boise, Idaho, June 17, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation,
U.S. Senate, Washington, D.C.

CHAIRMAN BYRD AND MEMBERS OF THE SUBCOMMITTEE ON TAXATION: The Idaho State Tax Commission wishes to state for the record that it is seriously opposed to the passage of S. 1688 and S. 983, bills prohibiting the states' use of the unitary method in determining the taxable income of multinational corporations and also limiting the ability of a state to tax foreign source dividends received by a domestic corporation. The Idaho State Tax Commission opposes these bills for the following reasons:

The State of Idaho derives a substantial portion of its corporate income tax revenues from multinational corporations having business activities within the State of Idaho. If these multinational corporations are allowed to shelter significant portions of their unitary business income from taxation by the states, the State of Idaho as well as the other states will suffer a drastic reduction in corporate income tax revenues. This would in turn put smaller-in-state businesses at a competitive disadvantage by increasing their relative tax burden.

Allowing unitary multinational corporate businesses to shift foreign expenses and domestic income between corporations, and then preventing the inclusion of the income supposedly "earned" by the foreign corporations in the combined income of the corporate group would obviously allow these multinational businesses to shelter large amounts of income from state as well as federal taxation. Section 482 of the United States Internal Revenue Code was theoretically designed to allow the Internal Revenue auditors to adjust income and expenses between foreign and domestic related corporations, but Internal Revenue personnel have flatly conceded that the Section 482 adjustments are not a workable method of enforcing arms-length transactions. Furthermore, the broad focus of the federal government is different from that of each taxing state with respect to prohibiting less than arms-length transactions between any two domestic and foreign corporations within a multinational group.

In the case of a multinational group whose parent corporation is in a foreign country and which has a subsidiary corporation with operations in Idaho, if the state were prevented from requiring the multinational from filing a world wide combination return, the subsidiary operating in Idaho, in cooperation with its parent, could show a loss in Idaho and thereby completely shelter its income from taxation by this state.

The Supreme Court of the United States has upheld the constitutionality of the world wide combined report, and in a decision just handed down, has rejected Mobil Oil Corporation's challenge to the constitutionality of the State of Vermont's taxation of dividends paid to a domestic corporation by a foreign subsidiary. In addition, the United States Senate recently removed Article 9(4) from the United States-United Kingdom Tax Treaty which would have attempted the same prohibition of the states' use of the unitary method in determining the taxable income from multinational corporations. The British House of Commons has ratified the U.S.-U.K. Treaty allowing the states' use of the unitary method.

For these reasons, the Idaho State Tax Commission strongly objects to the passage of S. 1688 and S. 983, and stresses the importance of the continuation of the states' use of the unitary method in determining taxable income of multinational corporations and the ability to tax foreign source dividends received by a domestic corporation.

Sincerely yours,

JENKIN L. PALMER, *Chairman.*

Senator BYRD. Thank you, Senator Church.

Senator CHURCH. Thank you very much, Mr. Chairman.

Senator BYRD. If the previous panel would come to the table. We are sorry for the delay. The Senate had three votes that it was necessary for the members of the committee to make.

Mr. Roemer has concluded his testimony. The next witness, I assume, will be Benjamin F. Miller, California Franchise Tax Board.

STATEMENT OF BENJAMIN F. MILLER, CALIFORNIA FRANCHISE TAX BOARD

Mr. MILLER. Thank you, Mr. Chairman.

For the record, the franchise tax board has already submitted a written statement, and at this time, at the request of Kenneth Cory, the comptroller of the State of California and chairman of the franchise tax board, I would also like to submit his statement, if I may have this admitted into the record.

Senator BYRD. Without objection, both will be received and printed.

Mr. MILLER. Thank you.

I would estimate that we have had about 3 hours of testimony today, Senator, and much if not all of it the franchise tax board disagrees with. I think one of the more cogent statements that has been made during this hearing was the question you yourself asked, sir. That is, "if what the States are doing is unconstitutional, then why is there any need for a law?" I think the answer is, there is no need.

Many of the problems which representatives of the corporate business world have brought up have been problems of a constitutional nature, either that the method used by the States is burdensome, it unfairly burdens interstate commerce or foreign commerce, it acts as a disincentive to investment, or it discriminates against those types of commerce. If that is the case, then the unitary method is in fact unconstitutional and there is no need for a law.

But in point of fact, the courts have never had any problem with that question. Time after time, the unitary method has been sustained by the courts. It has been sustained with respect to foreign operations and domestic operations.

One of the earlier witnesses was asked when the unitary method first became a detriment to foreign operations. I don't believe that it is. But I think we can go all the way back to 1924 to see when it was first applied. The U.S. Supreme Court in the *Bass Ratcliff* case upheld the use of a formula method with respect to a foreign-based corporation which was doing business in the United States. That corporation had reported no income to the State of New York, even though it earned an income on a worldwide basis. The Supreme Court held that the State could in fact use a formula method to fairly determine the amount of income which should be attributed to New York.

As recently as March, the U.S. Supreme Court in the case of *Mobil Oil* v. *Vermont* also sustained the use of the unitary method with respect to the taxation of dividends earned from operations in foreign countries.

One of the things that must be looked at in this area is what tax burdens would multinational corporations in fact pay if these bills passed. The answer is given by the *Vermont* case, the *Mobil Oil* case. If either bill 1688 or 983 were in place, the amount of tax which Mobil Oil would have paid to the State of Vermont for 2 of the years would have been $25, the minimum tax. It reported no income to the State of Vermont. Assuming the unitary method was applied by all States in Mobil's manner, Mobil would report no income to any State and would pay no tax to any State. To my mind, that is unconscionable. I do not understand how any major oil company can legitimately say that it earned no income and should pay no tax in any of the States in this country.

Mobil and the situation in Vermont is not unique. The same kind of situation occurred with Exxon in the State of Wisconsin. Again, the U.S. Supreme Court upheld the use of the unitary method in that case, and held that the oil companies do have to pay some tax to the States.

Again, the same situation was involved in a South Carolina case involving Exxon. The South Carolina Supreme Court sustained the tax in that case. It is my understanding the U.S. Supreme Court has also recently dismissed that case, citing the *Wisconsin* case.

This is a problem which is not unique to the oil industry. It has come up in a number of other areas. The U.S. Supreme Court recently considered the case of *ASARCO* v. *the State of Idaho*, Senator Church's State. Again, by the method which ASARCO chose to report to Idaho, they reported no income to that State, and would have paid no tax. Idaho used the unitary method, included dividends, and was able to assert a tax.

The fact that these corporate taxpayers can under the arm's-length standard report no income to the State jurisdictions suggests to me there is something fundamentally wrong with the arm's-length standard. It is just not proper for these corporations to pay no taxes to the States in which they are doing business.

One of the arguments which has been made by many of the representatives of business is that the unitary method is a disincentive to investments within an individual State. California's experience belies that, in spite of the testimony which has been offered.

Many people have said California is having trouble attracting foreign investment. Over the last 5 or 10 years, California has been the No. 1 State in attracting foreign investment, in almost every single quarter in every year. We do not have trouble attracting foreign investment. The statements of those who argue otherwise are inaccurate. The empirical evidence shows that it is just not the case.

In spite of the testimony that has been given today, there are certain corporate taxpayers which do favor the use of worldwide unitary method. California's own experience in the development of the unitary method was aided by several oil companies which wanted to take advantage of the unitary method. They sued California to require the use of the unitary method and sued successfully. This was back in the mid-1960's. Currently there is now pending a case before the Illinois Supreme Court involving Caterpillar Tractor. Approximately 9 or 10 corporations have filed an amicus brief in that case supporting the use of the worldwide unitary method by the State of Illinois. Among those corporations is the Continental Bank of Illinois.

Also, I think the committee should be aware of the fact that the General Accounting Office, at the request of the House Ways and Means Committee, is currently conducting a study of the unitary method, and also the arm's-length standard. We believe that it would be extremely precipitous for your committee to act on either of these bills pending the outcome of these studies, and we think these studies must be looked at together. You should not discard the unitary method without having an evaluation of the arm's-length method, and an answer to the question of whether or not it in fact provides an effective means to deal with the tax avoidance problems which the States encounter.

Thank you very much, Mr. Chairman.

Senator **Byrd**. Thank you, Mr. Miller.

It has been mentioned, I think, that legislation has been introduced in California to change the existing tax formula in regard to foreign corporations.

Mr. **Miller**. Yes, sir. There is currently a bill pending before the California Legislature which would restrict the use of the unitary method with respect to foreign owned or controlled businesses. This bill would provide that a foreign corporation which is owned or controlled by foreign interests would not be includable in a combined report.

That bill has passed the State assembly. It is currently before the State senate. The franchise tax board does not think it is a good bill. The principal argument that is being advanced in support of it is the disincentive argument. We believe the arguments that the unitary method is a disincentive to investment do not hold water. The franchise tax board is on the record in opposition to that particular bill.

Our principal fear with respect to the bill is that it would be extended beyond the foreign parent situation under the arguments which have been made here today. That is, you cannot just give a benefit to the foreign-controlled operations. You must give a similar benefit to the U.S.-based operations. The franchise tax board and the Governor of California are opposed to that concept.

There is no indication that the California Legislature would take action as far reaching as that involved in either S. 1688 or S. 983. Of course, we do not yet know the outcome of the bill that is currently pending as to whether it will pass or not, but I am fairly certain that there is no chance, at this point in time, anyway, to extend the scope of those bills to those contemplated by S. 1688 and S. 983.

Senator **Byrd**. Did the Governor and the tax board oppose the legislation when it was in the House?

Mr. **Miller**. The franchise tax board did, yes, sir. The Governor supported the legislation at that time.

Senator **Byrd**. The Governor supported it?

Mr. **Miller**. That's right, sir, with respect to foreign multinationals. At the time it was before our assembly, it also included a provision which would not give the benefits of the bill to energy companies or oil companies. That bill has now been amended so that the benefits of the bill are extended to oil companies, and it is not clear what the Governor's position would be at this time. We know that he was opposed to that amendment. Now, whether that will change his position with respect to the whole bill, we do not know.

Senator **Byrd**. It is now in the State senate?

Mr. **Miller**. Yes, sir.

Senator **Byrd**. Thank you.

May we have the next witness?

STATEMENT OF JONATHAN ROWE, ASSOCIATE DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. **Rowe**. Yes, Senator.

My name is Jonathan Rowe, and I am the associate director for an organization called Citizens for Tax Justice.

We are something of an anomaly here. We are neither corporate taxpayers nor State tax officials. I guess you might say we are the rest of us. We consist in part of organized labor, which is concerned with jobs and investment in the United States, and also small taxpayers.

At the beginning of the hearing, there was some invocation of the Constitutional Convention and the Founding Fathers. I would just like to read what Alexander Hamilton had to say about this issue, since it is before us.

This is from the Federalist Papers, No. 32. Alexander Hamilton there wrote:

> The individual states should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants. . . (and they should) retain that authority in the most absolute and unqualified sense. . . . (A)n attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of its Constitution.

If we are going to dress this legislation in the clothing of the Founding Fathers, then it is important to take account of what the Founding Fathers had to say on this issue. There is a practical side to that observation also.

This is not just an antiquarian exercise in outmoded principles. What we have heard today primarily is that one State, California, has been engaging in taxing policies that some multinational corporations don't like, and we heard testimony that in one case a particular company moved to, I think it was the State of Pennsylvania instead of California. This raises a very legitimate question: Is it the role of the Federal Government to decide in which State a particular company ought to locate?

Does it really hurt the State of Virginia, the State of Ohio, the State of Pennsylvania, if a company decides to locate in one of those States rather than in the State of California?

We hear that, well, the fact that California does it poses the threat that maybe the other States will do it. But if you read the business magazines, the Wall Street Journal, Forbes, Business Week, and the like, you discover that the reason that we are being flooded with capital from abroad is that the political climate here is considered to be so stable compared to other countries in the world where investment might be made.

So, I think that that argument is really not very persuasive.

Now, we have also heard a lot of testimony today to the effect that the States are reaching out their greedy hands and taxing a lot of income that is foreign income. The SEC reports of the State income taxes that are paid by major oil companies shed some light on this. I should point out that in 1977 the average taxpayer in the United States, who was making $16,000, was paying State income taxes of about 1.8 percent.

Now, here are the State income taxes that are being paid by some of the major oil companies. Continental, 0.3 percent; Standard of Indiana, 0.6 percent; Exxon, 0.7 percent; Mobil, 1.5 percent.

Our question is, Mr. Chairman, and I will conclude here, is that if there is all this over-taxation, if the States are reaching out with their greedy hands and taxing all this income that they have no right to tax, then why are the companies who are complaining actually paying such low tax rates? We think this issue requires a lot more study, a lot more investigation, and that the committee ought not to proceed just on the basis of allegations of a few corporate taxpayers.

Thank you.

Senator **Byrd**. Thank you, Mr. Rowe.

You quoted Alexander Hamilton, and mentioned unwarranted assumption of power by the Federal Government. Unfortunately, the people of this country have been subjected to unwarranted assumption of power by the Federal Government for the last 30 to 40 years. I wish that the country had adhered more in the past to the writings of Hamilton.

The next witness, please.

STATEMENT OF THEODORE W. DE LOOZE, CHIEF TAX COUNSEL, TAX DIVISION, OREGON DEPARTMENT OF JUSTICE

Mr. **de Looze**. Mr. Chairman, my name is Ted de Looze. I am chief counsel of the Tax Division of the Oregon Department of Justice.

Senator **Byrd**. If I could interrupt you just a moment, I know Senator Packwood wanted to be here when you testified, Mr. de

Looze. He has another commitment, and because of that interruption, those three Senate rollcall votes, he had planned to be here and wanted to be here, but because of that interruption, it threw his schedule off. Otherwise, he would be here.

Mr. de Looze. Do you want me to continue?

Senator Byrd. Yes.

Mr. de Looze. All right, sir.

Oregon is here in opposition to these two bills. It is hard to make an accurate estimate of the tax loss that might be incurred by Oregon, but we to the best of our abilities have estimated between $25 million and $30 million a year.

I appeared before the Ways and Means Committee and submitted a statement on H.R. 5076, and I have submitted statements today on both these bills. I mailed out 100 copies a week ago, Mr. Chairman. They haven't arrived, apparently. So I gave the reporter copies, and I would ask that they be included in the record.

Senator Byrd. Without objection, they will be so included.

Mr. de Looze. I am not going to repeat what has been said, but I am glad that some of the things have been said, and I think one of the most important things was said by you this morning, and that is that we are not political subdivisions of the United States, and as Mr. Rowe pointed out, somebody thought 200 years ago that we were given some kind of autonomous tax authority.

So, what we have is a balancing of authority between the State and the Federal governments, and it seems to me that what has to be taken into consideration by members of this committee is what the effect is as to States and their State revenues, and certainly the State taxing authority, and we ask you to do that today in considering these arguments.

Certainly, there is nothing better established than the principle that corporations can arrange the location of their income with a great deal of elasticity and using generally accepted accounting principles. They can use such devices as where they locate their inventory, what the pricing is, where the title passes, and a whole lot of other devices which help them determine where they can put their income to the best tax advantage.

What Mr. Miller said about the early case, the *Bass-Ratcliff* case, in the 1920's, it was the first indication that the States were waking up to the realization that this could occur. What has been said here already by one of your witnesses is that the process is an evolution.

Now, some 34 States use the unitary method to some degree, and I am sure that even Virginia, in determining the net income of a corporation, will take a look at that corporation and see if it is acting as one economic unit. Now, the natural extension of that concept has to take place when a corporation begins to change its methods of operation and operate through subsidiaries as well as the parent, and then you see the income can be attributed to those subsidiaries under whatever circumstances and whatever way the corporation deems most advisable taxwise.

So, it is this idea of extending the unitary operation to treat that situation the same as though there were one parent or one corporation that has required the States to extend the unitary concept not only domestically but overseas.

The *Mobil Oil Co.* case; here was a case where we had 400 subsidiaries. The *Exxon* case was a case where the company was operating as one corporation with divisions, and they were putting the income in certain parts of the corporation.

So, the principle is the same, and that is what the States are trying to get at. They are using the unitary method to say, here is an operation that is unitary. It is earning income. All the parts are integrated. They are dependent on each other. So what is the income of that unitary or economic unit? Then they apply an apportionment formula, and it is important to note that that apportionment formula represents only the activities in a particular State, and it apportions away from that State income attributable to activities outside the State.

So, as far as the States are concerned, this is not double taxation. This is a determination of where the income should be properly taxed.

Now, there has been a lot of talk about double taxation, and of course, you have to know what these people are saying. If the United States can tax a corporation and a State can tax a corporation, is that double taxation? Does that automatically make it bad? If the United States can tax an individual and the State can tax an individual, is that double taxation?

They are using double taxation in that sense. We are not talking about that. We are talking about the right of two sovereignties to tax income attributable to a particular activity, and that is why we believe that the unitary method should not be knocked out.

Now, S. 983, for example, goes far beyond the arguments made here today, and it would preclude the States, for example, from combining corporations that otherwise are doing nothing overseas, telephone companies, utilities, and so forth. So, we believe that the bill is not supportable by the States.

Senator **Byrd**. Thank you, Mr. de Looze.

Mr. Corrigan?

STATEMENT OF EUGENE F. CORRIGAN, EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION

Mr. **Corrigan**. Yes, sir.

My name is Eugene Corrigan. I am the executive director of the Multistate Tax Commission.

Mr. Chairman, I have here a letter from the United Auto Workers which was addressed to our chairman, and I have been requested to submit that for the record if I may.

Senator **Byrd**. Without objection.

Mr. **Corrigan**. I would request also, Mr. Chairman, that I be allowed to submit a formal statement and an accompanying document subsequently, and I would like to speak more informally at this time.

Senator **Byrd**. It will be received, and you may proceed.

[The material referred to, to be submitted, follows:]

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW

DOUGLAS A. FRASER, PRESIDENT
EMIL MAZEY, SECRETARY-TREASURER

VICE-PRESIDENTS
PAT GREATHOUSE • KEN BANNON • ROBERT WHITE • IRVING BLUESTONE • ODESSA KOMER • MARC STEPP • MARTIN GERBER

IN REPLY REFER TO
1757 N STREET, N. W.
WASHINGTON, D. C. 20036
TELEPHONE: (202) 828-8500

March 28, 1980

Mr. Alan M. Charnes
Chairman
Multistate Tax Commission
Suite 130
1790 Thirtieth Street
Boulder, Colorado 80301

Dear Mr. Charnes:

Throughout its history, our union has been committed to tax policies, at the federal, state, and local levels, that are fair to ordinary taxpayers and that contribute to a strong economy.

We believe that H.R. 5076 and S. 1688, which would prohibit the states from using the "unitary apportionment method" and from taxing dividends from foreign subsidiaries of multinational corporations, do not meet these standards.

By sheltering billions of dollars of corporate profits from taxation by the states, these bills would cut state revenues at a time when the approaching recession and federal budget cuts are putting a strain on the state's capacities to provide public services.

We are particularly concerned that, by giving a major tax subsidy for foreign investment, these bills will cost Americans, including members of our union, jobs.

Since we see no justification for federal action to shelter the profits of multinationals from fair state taxation, we join with your commission in opposing H.R. 5076 and S. 1688.

Sincerely,

Howard G. Paster
Legislative Director

HGP:cd
opeiu-494

Multistate Tax Commission

EUGENE F. CORRIGAN, Executive Director

July 7, 1980

Honorable Robert Byrd
Chairman
Senate Finance Subcommittee
  on Taxation and Debt Management
2227 Dirksen Senate Office Building
Washington, DC

Dear Senator Byrd:

Thank you very much for your courtesy and consideration during the June 24th hearing on S.983 and S.1688.

In accordance with the permission which you granted to me at the hearing, I herewith submit our formal statements and enclosures plus a copy of a letter which was addressed to our Chairman, Alan Charnes, by Howard G. Paster, Legislative Director of the U.A.W. We will very much appreciate your including these materials in the official record of the hearing.

To summarize our position briefly:

1. There has been no proper delineation of any problem which could possibly justify the enactment of either of the bills in question.

2. The bills would create tax advantages for large businesses over small ones.

3. The real problem is that large multinational businesses are already, in all too many instances, paying far less than their fair share of corporate net income taxes to the various states. The facts which were publicized in the recent U.S. Supreme Court cases involving Mobil Oil Co. and Exxon amply demonstrate the validity of this statement.

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4. The Congress should obtain factual data before it considers any action whatsoever in this field. That data should consist of full state and federal income tax data and returns plus support by documents from a representative group of multinational corporate businesses. We could be of some assistance in suggesting representative corporations.

5. The Congress should then analyze all of that information carefully to determine the extent of actual overtaxation or undertaxation in each case. We could supply auditors to assist in the performance of this analytical service. It is significant that all complaints by multinationals about multiple taxation by states is always framed in terms of potential, rather than actual, multiple taxation. On the other hand, audits on behalf of the states reveal a consistent pattern of undertaxation of such large corporate businesses.

6. Business testimony at the hearing maintained that the use of the unitary business is detrimental to a state using it. Of course, the answer is that, if a state which uses the principle considers the principle to be detrimental to its business climate, it can always cease to use the principle. The pendancy of AB 525 in California is an example of that. Meanwhile, if the testimony is to be believed, other states have an advantage by not using the principle...and business representatives are always maintaining that states should retain the right to create tax "incentives" for business.

7. The fact is that the use of the unitary business principle is increasing among the states because they are finding its use necessary as a means of coping with corporate taxmanship.

8. Congress has just enacted the windfall profits tax at the expense of the oil companies for the benefit of the federal government; it is hardly proper now for Congress to give the oil companies and their cohorts a huge tax break at the expense of the states and of smaller competition. If Congress wants to give those companies a tax break, it should do so at the expense of the federal government, not of the states.

9. By and large, the states are closer now than ever before to reaching agreement as to the type of federal legislation which could prove acceptable to them. In general, they oppose bad federal legislation such as is typified by these bills; but they well may be coming to

a position of support for legislation which would resolve interstate tax problems. We ask the Congress to be patient on that score.

10. Meanwhile, we submit that bad federal legislation is that which would, in the guise of responding to tax problems, create tax breaks for huge corporate businesses and which would have the effect of converting the states into mere political subdivisions of the federal government. S.983 and S.1668 would truly have that effect.

Thank you again for affording us this opportunity to express ourselves on these issues.

Sincerely yours,

Eugene F. Corrigan
Executive Director

EFC/cf
enc.

INTERNATIONAL DIVISION OF THE INCOME TAX BASE OF MULTINATIONAL ENTERPRISE *

by GEOFFREY JOHN HARLEY

A dissertation comparing arm's length transactional analysis of income allocation with the unitary method of formula apportionment, for income tax purposes, with emphasis on multinationals' use of transfer pricing and tax havens.

Submitted in partial fulfilment of the requirements for the degree of DOCTOR OF THE SCIENCE OF LAW at the UNIVERSITY OF MICHIGAN LAW SCHOOL.

Committee: L. Hart Wright (Chairman)
Paul G. Kauper Professor of Law

John H. Jackson, Professor of Law

William J. Pierce, Professor of Law

June 1980

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*The summary chapter of Mr. Harley's paper is set forth the following pages. The entire 431 page paper is included the Committee's official files for this hearing.

VII. SOME SUGGESTIONS AS TO HOW A UNITARY METHOD CAN BETTER PROVIDE AN INTERNATIONAL ALLOCATION SYSTEM

A. Why a Unitary-Based Method Is Better

Part VI developed the second part of the thesis presented in this paper. Arm's length transactional analysis--its theory aside--attempts the impossible. It strives to achieve an "accurate" result. In practice, arm's length results are only within broad ranges or zones of reasonableness, and often produce distorted allocations. Once these two aspects are recognized, the question of how best to allocate the income of a multinational between interested taxing jurisdictions reduces to a comparison of the two methods--arm's length and unitary--and what each achieves in practice. A perfectly accurate result is impossible. When the two systems are compared in that light, the thesis presented is that the unitary method of allocation is superior. It makes a rational measurement of earning capacity and it produces a definite and predictable result.

Part III criticized the U.S. regulations under § 482 in particular, and the manner in which the IRS polices them. In Part IV, it was suggested that the arm's length system will never operate satisfactorily, in terms of the criteria adopted for evaluation, even if the proposed modifications were all adopted.

The single most significant point to emerge from Parts III through V is that the arm's length mechanism is recognized to be inadequate to protect the tax base. While the various difficulties with the mechanism, detailed in Part III, are important, especially in terms of administrative justice, the most significant conclusion is that arm's length analysis fails to achieve the basic goal of ensuring that income is taxed to its real or true earner, and that expenses are deducted by the actual beneficiary of them. This goal is a fundamental principle for horizontal tax equity and has been the overriding criteria for evaluation throughout.

In many ways, the duPont case represents a watershed for the present § 482 regulations.[1] The facts involve a carefully orchestrated attempt to abuse arm's length pricing and expense allocations. If the regulations were going to work effectively, surely this was the case which would demonstrate it. The analysis of the case is disturbing. The IRS had great difficulty in making a re-allocation; in the end the Government abandoned defense of the method adopted by the IRS audit agent. While this paper argues that the re-allocation was legally invalid for this reason, the Commissioner was sustained by the Court of Claims only after introducing very detailed and complex evidence. The case took over 14 years to reach a result; by one estimate, each side's costs were over $1 million.[2] Given such provocative facts, one is entitled to look for something which is more responsive, certain and quick.

The best the Commissioner could achieve was a quite broad range of results. It is suggested that there is too much revenue at issue to allow such uncertainty in a case which should easily have yielded to a definite and simple determination without protracted negotiation and litigation.[3] Taxpayers are going to attempt to exploit the flexibility inherent in the "range of result" approach. "Reasonableness" or flexibility is unnecessary to the basic tax policy reflected by § 482; on the contrary, the dispute and abuse potential is so great, and the revenue at issue so large, that a concrete predictable result is considered to be an essential corollary to taxing income to its real earner.

The arm's length result is deficient. Even for taxpayers in compliance with the various rules, the United States has felt compelled to adopt additional mechanisms to protect further its tax base. Subpart F is specifically aimed at tax havens, and rests on the true earner policy. The arm's length standard actually reinforces the abuse potential of U.S. controlled tax haven subsidiaries.[4] Perhaps of more importance, because it involves a more subtle issue, is the controversial source/deduction allocation system, as it applies to domestically allowed deductions.[5] Given the basic premise of this system (that foreign countries are not bearing the true costs of the income which they tax but which is produced by U.S. corporations carrying on business in foreign jurisdictions), this thesis supports the U.S. Treasury's policy, as a logical and necessary extension of the real earner principle; foreign taxpayers benefitting from domestically incurred expenses should bear the full costs of producing their income.[6] The U.S. source/deduction system (the U.S. Model Treaty's Art. 7(3) aside) stops short of an allocation to the foreign taxpayer for practical reasons. It does limit the vulnerability of the U.S. tax base by restricting the foreign tax credit level; it goes as far as possible to achieve an effective unilateral solution.

These aspects all point to the need for a comprehensive allocation mechanism which avoids the dispute potential and which produces an internationally certain, predictable result. In this concluding Part, the unitary method is considered in three alternative forms, as the best solution. The first form is the unilateral adoption of the method by the U.S. This is impractical, although theoretically it is possible. The second alternative considers a multilateral system. A number of countries would have to accept the need for change, and then act in concert to implement it. A variation of this may be a series of bilateral agreements, but that course would not be nearly as effective. Finally, if the U.S. is unable to persuade its trading partners to change, the U.S. should act unilaterally, and adopt a limited unitary method aimed specifically at tax havens. Any U.S. business operating through a subsidiary in a designated tax haven would be subject to an allocation by formula and would be unable to rely on § 482. Subpart F would then be eliminated.

B. Unilateral Adoption of a Broadly Based Unitary System

In theory, it is possible for the U.S. to proceed unilaterally with a unitary method of international application to U.S. based multinationals. The Congress is legislatively competent to change the international tax system used by the U.S.; Subpart F is an example of a radical change being made.

A unilateral move may even be desirable. If the U.S. Treasury were convinced of the need for change, but other jurisdictions were not, principle suggests that unilateral moves would be appropriate.

A unilateral solution would have a tremendous disruptive effect, both for taxpayers operating from and to the U.S. and for other countries. Every U.S. tax treaty now in force would have to be abrogated. There would be no need to change the permanent establishment concept, but there would be no commonly agreed standard on which jurisdictional conflicts, otherwise resulting in double taxation, could be resolved. At least with the present system, the arm's length concept is well-recognized and provides a basis for negotiation, even if it has no standard content.[7]

The present tax treaty structure does not prevent double taxation. A unitary system will often produce a result widely different from an arm's length analysis; the results could not be reconciled on common ground. It would be possible for two countries simply to agree to "split the difference", or something similar, but the increased double tax potential is clear.

In any event, it is hardly conceivable that the U.S. would unilaterally abandon an entire tax treaty network, and body of wisdom, when its Treasury has been at the forefront in encouraging other countries to accept the structure. The international influence of the U.S. in the tax treaty area is unparalleled. That influence is partly a result of economic dominance by American multinationals and interests; more important, it seems to be the result of a widely respected international tax policy which has been carefully developed over many years. Professor Surrey's work in the area of international tax law and jurisdictional relations is preeminent; its results will not be abandoned by the United States acting alone.

C. A Multilateral Solution

(1) The Multistate Tax Compact

The best precedent on which to consider a multilateral solution is the states' membership of the Multistate Tax Compact.[8] There are three aspects. The first is the Compact itself (which is an inter-state "treaty"), which settles the basic rules for a common unitary system. It also establishes a centralized administrative agency with rule-making and enforcement functions. The third aspect is an arbitration system. While the Compact provided for arbitration of jurisdictional disputes, the states have never accepted it.[9]

There are real problems with the Multistate Tax Compact and they have to be seen in historical and constitutional perspective. Following an intense Congressional inquiry, and the introduction of federal legislation to regulate state taxation, the states were forced to produce a uniform state tax system before the Federal Government pre-empted them.[10] The Multistate Tax Compact resulted, and the federal legislation was not passed. The Compact provided for an administrative commission, with extensive rule-making and audit powers.

The Compact adopted the UDITPA as its uniform rule system. The Commission has issued a series of interpretative regulations which detail various aspects of UDITPA's rules.[11] For constitutional reasons, each member state is free to choose for itself the force of these rules and to alter its tax system. Membership of the Compact has no binding effect. This severely limits uniformity and it reduces considerably the effectiveness of the Compact.

(2) A Multilateral Treaty with Binding Effect

For international purposes, there would be no constitutional difficulty with adopting a binding treaty, which would be essential for an effective system. If a country were free to choose whether it would accept a unitary approach, supervised by an international agency, in any given case, the goal of uniformity would be lost and conflict potential would be resurrected immediately. The treaty embodying the unitary concept would have to be binding to be effective. Countries could not feel free to define their own standards and systems to suit themselves; uniformity is an essential if the goals set here are to be met. A disputed application of the agreed system raises a different issue discussed subsequently in the context of arbitration.

The major achievement of the Multistate Tax Compact is the adoption of the UDITPA. The international treaty would have to adopt an agreed allocation system. As with UDITPA itself, the international system would prescribe which taxpayers were subject to its jurisdiction, and prescribe in detail the allocation formula and the rules which would apply.[12] Specifically, the rules for the system would define "unity", detail the circumstances for combined reporting, develop the administrative aspects of the formula itself, the business/non business income distinction and so on, in the same way as the Multistate Tax Commission has.[13] Second, the system would have to provide for a broad administrative framework for enforcement and auditing. The Multistate Tax Commission audits multistate taxpayers as the agent for a member state.[14] Internationally, it may be desirable to reverse this process, as discussed below.

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(3) The Enforcement Process: Analogy to Existing Tax Treaties

The enforcement process in present bilateral tax treaties is being developed by the treaty parties arranging to audit jointly the operations of a single taxpayer. For example, suppose the U.S. wishes to audit the business of a U.S. based taxpayer which does substantial business in Canada. Under the U.S.-Canadian tax treaty, the U.S. can seek information from Canada under the information-exchange article. In addition, the U.S. and Canada can proceed to audit the entire international business jointly.[15]

The joint audit program is still tentative. For example, the audit plan and personnel are not "internationalized"; each country acts separately, and then exchanges the results.[16] In this way, each country is really acting as agent for the other, and both have a vested interest in the integrity of their own audits.

A multilateral treaty, of the type envisaged here, could be enforced quite effectively using this same mechanism. In a number of instances, it will only be necessary to involve two countries. There is little point in using an elaborate administrative structure to do what is effectively and properly done bilaterally. In other cases, especially those involving the very big multinationals, the issues are much more complex. For example, the Ford Motor Company operates through subsidiaries in many countries and areas such as Canada, Europe, Australia and South America. To determine the proper allocation of income among a large number of interested jurisdictions, by a unitary method, a central agency would be practically essential.

To continue the example, the Ford Motor Company is now subject to a large number of different tax liabilities internationally. Such a multinational enterprise, with arm's length issues, cannot appeal to a central body; bilateral tax treaties do not permit a multilateral solution. The U.N. Experts did consider a multilateral treaty, but not in any detail.[17] For a unitary system, the allocation of income could be achieved on a bilateral level; the difficulties arise when such allocations have to be made in a series, where each jurisdiction has different interests to promote. The overlapping and conflicting claims would become so numerous that a central authority would be needed to make an international unitary system work effectively.

For audit purposes, it would still be possible for the central agency to use the capacities of an individual member's tax administration. For multinationals operating in several countries, the essential for an audit would be a centrally coordinated and targeted approach. Much of framework necessary is already in place in existing tax treaty arrangements for joint audits. It would be a short step for countries to accept a central body to coordinate audit strategies.

(4) The Need for Arbitration of Disputes

A politically difficult issue concerning an international agency concerns its powers to settle disputes as between taxpayers and members, and between the members themselves. Suppose, for example, that a corporation operates in three countries and is partially subject to the unitary system. Now, Country A considers that the corporation is, in fact, unitary and it requests the agency to make the necessary determination. Countries B and C both cooperate, and after an investigation, the agency considers that Country A is wrong, but that the corporation is unitary between B and C's jurisdiction, as previously determined. Nevertheless, Country A remains convinced, and wishes to assess its share of allocable income under the international unitary system. This hypothetical raises a number of delicate issues.

First, as discussed above, there is nothing in theory to stop a country from adopting a unitary system unilaterally.[18] Thus, in the example, Country A would be able to proceed against the corporation, using any tax theory it considered appropriate and was competent to enforce. However, if Country A decided to proceed, the uniformity purpose of the multilateral agreement and its agency would be compromised. Should the issue be arbitrated to achieve a settlement?

The Multistate Tax Compact provided for an arbitration system. The Compact provided for a widely representative arbitration panel to act when taxpayers were dissatisfied with the Commission's administrative determination. The arbitration was to be binding on the affected states. This Article of the Compact has never been accepted.[19]

There can be little doubt, from a strictly legal viewpoint, that an arbitration system would greatly assist the promotion of uniformity. It would resolve many of the difficult administrative issues and ensure that double or multiple taxation claims were ordered in priority to prevent actual multiple taxation. The real issue is not the desirability of arbitration legally, and for taxpayers, but the political implications for each of the jurisdictions submitting to it.

Submission of a problem concerning the right to tax in a certain way to an independent, outside, body is a partial relinquishment of sovereignty. How desirable is it, for example, for the U.S. to submit an issue of taxation concerning General Motors or Exxon--both American owned enterprises--to an authority independent of the U.S. for resolution? It may be that some kind of world tax court is appropriate[20]; for present purposes, it is unnecessary to go so far. It would be sufficient for an arbitration to take place, which would be non-binding.

The present tax treaties provide for settlement of jurisdictional disputes through competent authority negotiations. This system works very well, but it is not binding.[21] A country is now free to reject completely the position of another taxing jurisdiction, and to let the consequences of double taxation fall where they may. This can happen.[22] An arbitration of an issue will produce a reasoned result. In the writer's view, a country would be slow to reject an arbitrated result, and assert its own position, when the consequences of it doing so are clear. Uniform taxation would be lost. However, it is unlikely that a country would be willing to surrender the right to tax as it chooses, even if the practice is to do so. It seems likely that non-binding arbitration would be as far as a country would be willing to go; it would be workable but not perfect.

(5) A Common Tax Base

At least three commentators have suggested that without a common tax base, an international allocation system could not be embodied in a multilateral agreement. The inference is that a common tax base would be impossible to achieve, thus dooming a multilateral system.[23] The writer suggests that this is not so; domestic policies can be simply accommodated by a multilateral system, as shown by the following example. A common tax base is necessary and achievable.

Suppose that Parent Corporation, an American multinational, operates in France, West Germany and the United Kingdom. While the United Kingdom permits a 100% capital write-off for new equipment, and the U.S. allows generous accelerated depreciation, suppose France and West Germany allow only a set depreciation percentage. How can such differences be accommodated? To complicate matters, the U.S. has an investment credit for new capital equipment, restricted only to U.S. taxpayers. How could that policy be maintained in the face of an international system? The answer to these questions is quite simple.

The common denominator is that each country has an income tax. Each acknowledges that net income, at least in theory, cannot be assessed without allowance for capital depreciation. The difference between them is that some countries offer larger rates than others, and, in the example, the U.S. and U.K. offer tax preferences to the taxpayers investing locally. Those policies can all be accommodated if the international allocation system adopts a common depreciation rate, to assess net income subject to allocation. Once the allocation is made, each country is free to tax the allocated share it receives as it sees fit. If Britain wishes to allow a 100% capital write-off, it would bear the tax base loss itself, because that write-off would be made against its allocated share. The U.S. investment credit would apply to the amount allocated to the U.S. The individual rates of taxation are rendered equally irrelevant to the allocation process.

Developing a common tax base would not be very difficult;

it would involve defining an income tax system with commonly accepted standards for deductions, taxable income, and so forth. But, once it is appreciated that each country can treat the income allocated to it as it wishes for its own tax purposes, the difficulties are not nearly as great. A multilateral agreement needs only to define net income for allocation purposes; each country can define its own net taxable income as it chooses.

There is already wide consensus between existing corporate income tax systems.[24] Countries are unlikely to argue about profits from sales of trading stock as being taxable events, and could simply settle on a common rule for accrual of income. The deductibility of expenses for wages and salaries, purchase of raw materials, maintenance costs and so forth are straightforward matters. A common cost-of-goods sold measure would not be hard to detail, largely because it would only measure net allocable income, and not net taxable income.

(6) A Political Decision to Proceed

The major problem in terms of a multilateral solution is that there is no consensus on the need for change; the political will to make certain that a multilateral treaty is developed and adopted is non-existent. Once that consensus is achieved, the second step is the development of an intricately detailed allocation system, and the necessary administrative features of it.

The dominant concern of any given jurisdiction is the maintenance of its revenue base; it is considered naive to argue that countries ought to abandon their own tax policies to achieve pure tax neutrality. The unitary system can easily accommodate domestic tax policies. For that reason, the detail of a formulary system is not as important for countries (so long as it reasonably reflects an individual taxpayer's activities in a given jurisdiction) as is the need to see the reasons for change.

If the U.S. were to move in the direction of a multilateral solution, its trading partners would be impressed. The U.S. influence in international tax policy development is profound and dates to President Kennedy's 1961 program. The impetus for the present structure came from the President's tax program; impetus can be given with a new system. An important aspect to gaining a consensus is explaining the tremendous benefits to be obtained from an international solution. The U.S. has as much to gain as any country in this regard.

(7) Effects of an International Solution

The effects of a multilateral treaty, embodying a unitary method, can be seen in two parts. The U.S. perspective is considered first. The interests of other countries, particularly developing nations, is discussed next, especially in terms of present tax treaties.

(a) Present U.S. Tax Structures and Policies

The Internal Revenue Code has five different concepts to effect U.S. international tax policy. A unitary system would leave the foreign tax credit in place, and substitute one new concept for the four replaced.

The present structure consists, first, of source rules.[25] These define jurisdiction to tax by settling the U.S. tax base. Tax treaties refine source concepts further. Second, § 482 seeks to ensure that sources are not manipulated. Section 482 is then reinforced by the provisions in the source/deduction allocation system[26] and by Subpart F.[27] All three operate on the physical location of earning processes. These four systems, so closely inter-related, would be replaced with one which would have the same purpose, but which would achieve it in a much simpler and more effective manner. The remaining policy--taxation of repatriated foreign source income subject to the foreign tax credit[28]--would remain unaffected.

Apart from the simplification, and the practical elimination of the abuses associated with tax havens, the U.S. would achieve what it is now most concerned with. The dominant concern of the U.S. Treasury is now the burden of deductions taken against the U.S. tax base but which produce income in other countries.[29] Because the unitary system avoids completely the need to make allocations of deductions--the method allocates net income only--the friction generated by the U.S.

policies under § 482 and source deduction rules is eliminated. The scope for double taxation and negotiated settlements between jurisdictions would be greatly reduced.

The converse is equally true for U.S. trading partners. Countries such as Canada do not need to be concerned with verifying the basis of U.S. inspired expense allocations under a unitary system.[30] Rightly or wrongly, these countries now feel that the U.S. is over-promoting its concern with expenses. Net income allocations avoid the issue, but accommodate the concerns of both parties.

(b) Tax Treaty Policy: Developing Countries

As noted in Part III C, many developing countries are unwilling to accept the present structure of tax treaties. This lack of acceptance inspired the UN Group of Experts to recommend substantial changes; as the seven reports show, there will be considerable debate as to the precise form of these changes. It is difficult to predict how much impact the UN work will have. As Professor Surrey notes:[31]

> The reports of the UN Group . . . provide a full informative background for treaty negotiators . . . [and] . . . demonstrate considerable agreement on many issues. When such agreement has not been reached, the reasons for and the extent of the disagreement are fully described. . .

At least one commentator has dismissed the work as being unhelpful to developing countries, concluding that[32]

> . . . [T]ax treaties do not appear to be able to solve the problems of developing countries with respect to transfer pricing. Disputes that will inevitably arise could perhaps be settled through the aid of . . . binding arbitration. But the necessity of resorting to such measures as a result of the inferior position of developing countries is inconsistent with the assumptions underlying the bilateral approach. For developing countries, the case for a multilateral solution is strong.

As the same commentator goes on to observe, a multilateral solution would require the kind of institutional framework discussed earlier, which would greatly aid the position of developing countries.[33]

A unitary-based formula ought to have considerable theoretical attractions to developing countries. The issues of income classification, withholding rates on royalty, interest and fees income, and the location of income for sources are all settled by a formulary allocation. There is considerable dispute potential between developed and developing countries as to the relative weighting of a formula. Without doubt, a system which allocates capital heavily will be resisted by developing countries; developed countries will insist on a formula which adequately recognizes the capital base. These difficulties are real;[34] the alternative is for developing countries not to enter tax treaties which unfortunately is the present state of affairs. It hurts them and it must inhibit the growth of trade. The present structure of tax treaties is now unacceptable to developing countries, and the arm's length standard is so deficient and difficult to administer that they should be slow to adopt it. For the same reasons that the states of the U.S. have turned to the unitary system, developing countries ought to consider it as an alternative.

D. Replacement of Subpart F

In the absence of a multilateral solution, for the U.S. the replacement of Subpart F is recommended for three reasons. First, Subpart F can be avoided with sophisticated tax planning techniques and specifically structured arrangements to sidestep its "base company" classifications. Second, it was submitted in Part V, in some cases, Subpart F reaches too far and in a way which inevitably leads to clashes with other countries sharing the same concern with tax haven operations. The third is that, while severely restricting the effectiveness of tax havens, and solving the tax-free transfer of assets issues under § 367,[35] a unitary method would also provide valuable experience and impetus on which other nations could judge the method. In short, it could operate as a "testing ground" for a multilateral solution.

The proposal here is as far-reaching as the quasi-formula amendment considered for § 482 in 1962.[36] The House of Representatives proposed that the quasi-formula be used where an "arm's length price" could not be established.[37] The "arm's length price" was defined to mean a comparable uncontrolled price, with or without adjustments.[38] It is doubtful that a parent company could ever establish a CUP price where it was selling to a captive base company; for this reason, and to prevent arm's length pricing from reinforcing a base company's utility through back-to-back financing,[39] the proposal here is a "bright line" rule. Tax havens would need to be designated, either by name, or by measurement of effective tax rates with a stated triggering percentage.[40]

Any corporation trading in the U.S., which buys or sells products or services through a tax haven subsidiary, would be subjected to formulary apportionment on the basis of a combined report. This would measure the real earnings of the base company, and respect that earning capacity. The proposed amendment to § 482 would have allowed the Commissioner to ignore a foreign entity:[41]

> . . . whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States.

The unitary method would have practically the same effect for such entities, although that may not be the case in all circumstances, depending on the degree of activity of the subsidiary which would not be eliminated by a combined report.

Such a system will not meet many of the goals considered to be important in this thesis. It would not prevent double taxation, nor would it address the problems of the arm's length method where tax havens are not involved. Finally, it fails to address the U.S. concern, considered legitimate here, concerning the undue erosion of its tax base by deductions. International tax harmony on allocations of income requires more than a unilateral solution dealing with tax havens.

E. Conclusion

The international adoption of a multilateral system embodying the unitary method to replace the present arm's length standard will take years. The most important step is for developed nations--especially the U.S., Canada, Europe and Japan--to recognize the unitary concept's theoretical superiority and the possibilities it has to produce true international tax harmony, for both developed and developing nations. From that point, the development of the system becomes possible. Until such a consensus is developed, the U.S. must contemplate a unilateral solution to its difficulties with tax havens. A unitary system to replace Subpart F would greatly assist.

PART VII. FOOTNOTES

[1] duPont de Nemours & Co. v. U.S., 608 F.2d 445 (Ct. Cl. 1979) cert. denied 445 U.S. ___ (1980).

[2] Kauder: International Allocations of Income p. 27. The suit was filed in 1966 and finally resolved in 1980.

[3] The evidence was clear and unambiguous that duPont did not even attempt to estimate arm's length prices; see the Court of Claims opinion supra fn. 1, esp. pp. 447-448 and accompanying footnotes 4 through 7.

[4] See Part V ante.

[5] Reg. § 1.861-8.

[6] These policy aspects are detailed in Parts II C and III A(7) and (8).

[7] See Part III C ante.

[8] Calif. Rev. & Tax Code § 38001.

[9] Discussed infra at Part VII C(2).

[10] After the Supreme Court's decision in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), the Congress set up the Special Committee on State Taxation, referred to as here, by the reports, as the Willis Comm. H Report 1480 on State Taxation. These reports resulted in H.R. 11798 (the Willis Bill, 89th Cong. 1st Sess.) which prompted formation of the Compact. For an historical overview of the Compact's development, see U.S. Steel Corp. et al. v. Multistate Tax Comm., 434 U.S. 452 (1978).

[11] See Part VI C ante.

[12] The treaty would have to settle the commonly applicable allocation formula; unlike the Multistate Tax Compact, countries would not be free unilaterally to depart from the common standard for allocation purposes. This is the major problem of the Compact because it destroys uniformity and encourages overlapping tax claims.

[13] The international agency would have to develop detailed regulatory positions, of general application, to resolve doubts and promote uniformity.

[14] See Art. VIII of the Compact; Calif. Rev. & Tax Code § 38001.

[15] See the joint audit program announced June 17, 1977; IR 1839. For the US-UK arrangement, see IR 1965 of March 2, 1978. These bulletins are reprinted in Gifford & Streng's International Tax Planning (2d ed., 1979) pp. 219-223.

[16] Both programs, supra fn. 15, make this point explicitly; see, for example, Art. IV, sec. 4 of the U.S.-Canada agreement.

[17] See Chapters VII-IX of UN Report 7 on Tax Treaties pp. 57-62. As Professor Surrey noted in Surrey: UN Experts' Tax Treaty Guidelines pp. 62-63, the UN Group was committed to developing bilateral solutions. A multilateral solution was "too ambitious" and "premature"; UN Report 7 on Tax Treaties p. 63.

[18] Part VII B ante.

[19] See the analysis in Note, State Taxation of Interstate Businesses and the Multistate Tax Compact, 11 Columb. J. Law & Social Problems 231, 254-280 (1975). For a discussion of arbitration in the context of international arm's length disputes, see LeMont: The 482 Mess p. 431.

[20] See generally Kragen, Avoidance of International Double Taxation Arising Under Section 482 Reallocations, 60 Calif. L. Rev. 1493, 1516 (1972) as to why the U.S., for example, would be reluctant to accept a world tax body. See also Madere, International Pricing: Allocation Guidelines and Relief From Double Taxation, 10 Texas Int'l L.J. 108, 134-5 (1975) and Linde: Regulation of Transfer Pricing pp. 100-102.

[21] Supra fn. 19.

[22] I.e., there is no obligation in Art. 25 of the U.S. or O.E.C.D. Models to reach an agreement; it is conceivable that the treaty parties cannot agree although the authorities do not acknowledge that this has happened; see Part III C where the competent authority mechanism is reviewed.

[23] Park, Fiscal Jurisdictional And Accruals Basis Taxation. . ., 78 Columb. L. Rev. 1609, 1652 (1978) whose view is rejected in Part V F ante, see also Linde: Regulation of Transfer Pricing pp. 102-123 and the criticism of Nolan as to California's current practice in Dexter/Nolan: Art. 9(4) of the US-UK Tax Treaty p. 408, discussed in Part VI C ante. See also UN Report 5 on Tax Treaties pp. 22-23.

[24] See Part II B(2) ante.

[25] IRC § 861-4, 881-2.

[26] Reg. § 1.861-8.

[27] See Part V ante.

[28] IRC § 901-4.

[29] See President Carter's 1978 Tax Program, discussed in Part V D ante.

[30] Robertson, The Use of Tax Evasion and Tax Avoidance by Multinational Companies: A Canadian View, 25 Can. Tax J. 513 (1977).

[31] Surrey: U.N. Experts' Tax Treaty Guidelines p. 65.

[32] Linde: Regulation of Transfer Pricing p. 93.

[33] Linde: Regulation of Transfer Pricing pp. 100-102.

[34] Linde: Regulation of Transfer Pricing p. 120; some suggested solutions are discussed in Part VI C.

[35] See the discussion of Part V D(1)(b) ante.

[36] Sec. 6 of the Revenue Act of 1962; H.R. 10650, 87th Cong. 2d Sess., discussed in Part IV B ante.

[37] Proposed Sec. 6(b)(1) and (4), supra fn. 36.

[38] Supra fn. 37.

[39] See the discussion in Part V for a discussion of the cases involving these techniques.

[40] Designation is the preferred method of Japan; see Brockman, Japan: Taxation of Undistributed Profits of "Designated Tax Haven Subsidiaries" 79-3 Tax Management International Journal 3 (March 1979). Assessment of "effective rates" is the system preferred by West Germany's Foreign Tax Law, discussed in Part V E ante.

[41] Proposed Sec. 6(b) supra fn. 36.

STATEMENT OF

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IN THE HEARING BEFORE THE
FINANCE COMMITTEE OF THE UNITED STATES SENATE,
JUNE 24, 1980, ON S.983

I. INTRODUCTORY STATEMENT

The Multistate Tax Commission, composed of nineteen regular member states and twelve associate member states, unequivocally opposes S. 983. This bill unjustifiably and artificially limits the employment of the unitary concept for state income tax purposes and violates basic principles involved in the apportionment of net income. In addition, it unjustifiably exempts from state and local income taxes large blocks of income from intangible properties either outright or by assigning such income to "foreign sources" or the commercial domicile where this income is not subject to taxation. It also artificially restricts the jurisdiction of the states and their political subdivisions to impose gross receipts taxes and to require the collection of sales and use taxes on "interstate sales".

In substance, the bill is designed to overrule numerous decisions of the Supreme Court of the United States by granting to multistate-multinational taxpayers the immunities and preferences denied them by those decisions.

Contrary to the proponents of the bill, the bill does not provide any uniformity and it does not ease compliance burdens. It simply superimposes on the existing state and local tax system various exemptions and restrictions. It thereby compounds, rather than simplifies, existing non-uniformity and current compliance burdens. It does not represent a compromise of the position of the states and the business community over the content of any federal legislation. It is not a joint work product of the states and the business community. It is simply a business sponsored bill. It is thus highly misleading to characterize the bill as a compromise bill as the result of hearings on S. 2173, Senator Mathias' earlier bill.

Any such bill would destroy the tax and fiscal integrity of the states and their political subdivisions by the granting of unwarranted tax preferences to large multinational corporations, whose size and complexity permit them to successfully play the "corporate shell game" on a worldwide scale and to otherwise arrange their affairs to escape their fair share of state and local sales and uses taxes, gross receipts taxes and net income taxes. The end results of the bill are (1) the loss of or denial of access to substantial tax revenues by the states and their political subdivisions, and (2) tax discrimination against local business and in favor of multistate-multinational businesses. The bill is thus detrimental to the legitimate interests of the states, their political subdivisions and that great portion of the business community (including all local businesses) which is not in a position to take advantage of its restrictive features.

The Multistate Tax Commission and its member states are unequivocally opposed to the bill.

In support of the foregoing, we will now turn to an overview of the general structure of the bill, a detailed analysis of its provisions and specific comments on various provisions in the bill.

II. GENERAL FEATURES OF THE BILL

Title I deals with sales and use taxes. Title I contains jurisdictional restrictions, base restrictions, and restrictions on the liability of sellers for state and local sales and use taxes. Title II imposes a high threshhold jurisdictional restriction on states and their political subdivisions for gross receipts tax purposes. Title III contains various base, apportionment and "combined" reporting restrictions which must be complied with by the states and their political subdivisions in imposing their net income taxes on multistate-multinational corporations. Title VI confers de novo jurisdiction on the United States Court of Claims over any issues relating to a dispute arising under the bill or under Public Law 86-272. Title V prohibits out-of-state audit charges and limits liability of any person for unassessed taxes.

III. TITLE I - SALES AND USE TAXES

A. Sales and Use Tax Jurisdictional Restrictions.

Section 101 prohibits a state or political subdivision thereof from requiring any person to collect a sales or use tax with respect to a sale of tangible personal property unless the person has a business location in the state or the political subdivision, or regularly engages in deliveries in the state or political subdivision other than by common carrier or the United States postal service or regularly solicits orders for the sale of tangible personal property by means of salesmen, solicitors or representatives in the state or political subdivision. "Business location" is defined in Section 157.

As there indicated, a person is considered to have a "business location" within a state only if that person (1) owns or leases real property within the state; (2) has one or more employees located in the state; or (3) regularly maintains a stock of tangible personal property in the state for sale in the ordinary course of business. Property on consignment or property in the hands of a purchaser under a sale or return arrangement is not "a stock of tangible personal property".

Under Section 159, an employee is considered to be located in a state only if (1) his service is localized in the state; or (2) if his service is not localized in any state, some of his services are performed in the state and his base of operations is in the state. Furthermore, an employee's service is not localized in the state unless his service is performed entirely within the state or the service performed without the state is only incidental to his service performed within the state. An employee's base of operations is "a single place of business with a permanent location which is maintained by the employer and from which the employee regularly commences his activities and to which he regularly returns in order to perform the functions necessary to the exercise of his trade or profession."

Section 159(d) entitled, "Continuation of minimal Jurisdictional Standard" applies the restrictions of 86-272 (concerned solely with net income taxes) to sales and use taxes. Section 159(d) is not a continuation of minimal jurisdictional standards for sales and use taxes. It provides that an employee is not located in the state if his only business activities within the state on behalf of his employer are: (1) the solicitation of orders for the sale of tangible personal property which are sent outside the state for approval or rejection and if approved, are filled by shipment or delivery from a point outside the state; or (2) the solicitation of orders for sales of or for the benefit of a prospective customer of his employer if such cutomers's orders are accepted and filled from sources within the state. Further, Section 159(d) excludes employees that install or repair personal property in the state incidental to an interstate sale.

Section 159(e) provides that employees of contractors and extractors, whose services in the state are related primarily to the performance of the contract, are presumed to be located in the state. Section 159(e), however, does not apply to services performed in installing or repairing tangible property which are incidental to an interstate sale. Section 159(f) defines an employee as a person subject to withholding for federal income tax purposes.

Section 101(c), as an additional jurisdictional restriction, exempts transportation charges with respect to interstate sales if separately stated by the seller. In many instances, freight charges are a substantial portion of the total consideration paid for tangible personal property. This exemption places local sellers at a disadvantage since freight charges for interstate shipment are a part of their costs prior to any sale. It would appear that the simpler, more equitable, rule, would be to require that all freight or transportation charges be included in the use tax base. This would place interstate sales on an equal footing with intrastate sales and eliminate any uncertainty and discrimination.

All of these jurisdictional restrictions would undermine the ability of the states tand their political subdivisions to enforce their sales and use tax laws. Title I contains unwarranted restrictions on the ability of the states and their political subdivisions to impose and collect sales or use taxes. A person could conduct sales activities in the state through independent agents without any limitation whatsoever. No out-of-state seller would be liable for the collection of any sales or use taxes for a state or its political subdivisions if the employees operated out of their homes. Futhermore, they could conduct unlimited activities within the confines of one state operating out of their homes so long as the sales are accepted out of state and the goods are shipped from sources out of state. It is difficult to conceive how the jurisdictional restrictions of Title I are responsive to the legitimate sales and use tax collection responsibilities of the states and the compliance needs of the business community. Standing alone, and particularly when considered in light of other restrictions contained in Title I, these jurisdictional restrictions are wholly unacceptable to the Multistate Tax Commission and its member states.

B. Title I - Other Sales and Use Tax Jurisdictional Restrictions. Section 102 purports to be restricted to the subject matter of "Reduction of Multiple Taxation". However, Section 102(a) contains an additional jurisdictional restriction. Sales and use tax liability is limited to where the destination of an interstate sale of tangible personal property is in the state or in a state or political subdivision for which the tax is required to be collected. "Destination" is defined in Section 155 of the bill as the state where the property is shipped or transferred to the purchaser. Presumably, then, if the property is transferred to a designee of the purchaser no state or political subdivision would have jurisdiction to tax the sale. Also, Section 102(a) would apparently exempt rentals from any sales or use tax liability. If Section 102(a) and (b) are intended to simply reduce multiple taxation, they should be reworded to prevent any state other than the destination state or political subdivision from imposing any sales or use tax liability if the destination state or political subdivision has jurisdiction to do so. Futhermore, the destination should include shipments directly to a designee of the purchaser and include the use of rental property in the state.

Section 102(c) provides a credit for prior taxes previously paid by the taxpayer with respect to tangible personal property on account of liability to another state or political subdivision thereof. Since sales and use tax liability is imposed in respect to the transactions involving tangible personal property, the credit provided for in 102(c) should be applicable only with respect to the same transaction regarding the same tangible personal proerty. It is not multiple taxation within the purview of sale and use tax laws to impose sales and use tax liability in respect to two or more transactions involving the transfer of the same tangible personal porperty.

Section 102(d) providing for credit for prior taxes and Section 102(e) providing for refunds are subject to the same defect as Section 102(c). Both relate to tangible personal property rather than to transactions. Nor is it clear how Sections 102(d) and (e) interrelate.

C. Title I - Liability of Sellers for Collection or Payment of Sales or Use Tax on Sales to Business Buyers. Section 102 exempts any out-of-state seller from liability for the collection or payment of a sales or use tax with respect to an interstate sale of tangible personal property if the purchaser is registered to collect or pay a sales or use tax or furnishes the seller with a certificate or written form of evidence indicating the basis for exemption or the reason the seller is not required to pay or collect the tax. Section 103 should contain a good faith provision.

Section 106 pertains to local sales and use taxes. It relieves any seller from classifying interstate sales according to destination by political subdivision. In light of the high threshold for jurisdiction in Title I, this provision is unduly restrictive. The states, to our knowledge, do not disagree with the general intent and purpose of such a provision under a reasonable jurisdictional standard.

IV. TITLE II - GROSS RECEIPTS TAX

Title II provides that "no state or political subdivision thereof shall have power to impose a gross receipts tax with respect to the interestate sale of tangible personal property "unless the sale is solicited directly through a business office of the seller in the state or political subdivision." "Interstate sale" is defined by reference to Title I as a sale in which the tangible personal property sold is shipped or delivered to the purchaser in the state from a point outside the state. "Business office" is in a state or political subdivision only if the taxpayer (1) owns or leases real property within the state or political subdivision; or (2) regularly maintains a stock of tangible personal property in the state or political subdivision for sale in the ordinary course of business. A stock of tangible personal property does not include property on consignment and property in the hands of a purchaser under a sale or return arrangement. If the definition of "a business office" as defined in Section 252 is substituted for the phrase, "a business office" in Section 201, the substance of the jurisdictional restriction is as follows: "No state or political subdivision thereof shall have power to impose a gross receipts tax with respect to the interstate sale of tangible personal property unless the sale is solicited directly through owned or leased real property within the state or political subdivision or regularly maintained stock of tangible personal property in the state or political subdivision for sale in the ordinary course of business of the seller in the state or political subdivision." This does not make sense. Sales are not solicited through the ownership or leasing of real property or through the maintenance of a stock of tangible personal property in the state or political subdivision.

Notwithstanding this incongruous language, the jurisdictional restriction applicable to gross receipts taxes apparently was intended to immunize from gross receipts taxes all gross receipts which were not solicited by salesmen, agents, or other employees of the taxpayer from inventories or from a business office owned or leased by the taxpayer in the state. As a practical matter, this would exempt all interstate sales from gross receipts taxes. It is hard to imagine any broader.restriction on a state's power to impose gross receipts taxes on interstate sales. It represents such a flagrant restriction on state taxing powers that it deserves little additional comment. It is obviously intended to overrule General Motors Corp. v. Washington, 377 U.S. 436 (1964) and Standard Pressed Steel v. Department of Revenue, 419 U.S. 560 (1975).

V. Title III - NET INCOME TAXES

Title III does not contain any jurisdictional restrictions on the power of a state or its political subdivisions to impose a net income tax. The jurisdictional restrictions of Public Law 86-272 are left intact. Title III, however, does contain significant and far-reaching restrictions on the taxing powers of the states and their political subdivisions. These restrictions are interrelated and result in exempting a substantial portion of the income of multistate-multinational businesses from state and local income taxes. After analyzing the provisions of Title III of the bill, we will consider their interrelationship and analyze the effects of such provisions.

A. Analysis of Title III of the Bill - The Restrictions On State and Local Powers to Impose Income Taxes On Multistate-Multinational Corporations

1. Section 301 Restrictions. Under Section 301, a state or political subdivision thereof may not impose on a corporation taxable in more than one state, other than an excluded corporation, a net income tax measured by an amount of net income in excess of the amount determined by (a) multiplying the corporation's base by an apportionment fraction which is the average of the corporation's equally weighted property, payroll and sales factors as defined in Section 355, 356, and 357, plus (b) the amount of income allocable to the state. The base to which the apportionment fraction is applied is the corporation's apportionable income as defined in Section 354 of the bill. Furthermore, no state shall, by reason of not including dividends or foreign source income in apportionable income, make any offsetting adjustment of an otherwise allowable deduction which is unrelated to the excluded dividends or foreign

source income. The significance of these limitations can be understood only in reference to other sections of the bill.

2. Section 302 Restrictions. Section 302 exempts so-called "foreign source" income (including dividends) and dividends received from corporations in which the taxpayer owns 50% or more of the voting stock. It provides for the allocation to the commercial domicile of any dividends which are not exempt. Dividends are defined in Section 359 of the bill as dividends under the Internal Revenue Code of 1954, as amended, including any sum treated as a dividend under Section 78 of the code. "Foreign source" income is defined in Section 358(a) as (1) interest other than interest derived from sources within the United States; (2) dividends other than dividends derived from sources within the United States; (3) rents, royalties, license and technical fees from property located or services performed without the United States or from any interest in such property, including rents, royalties or fees for the use of or the privilege of using without the United States any patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises and other like properties; and (4) gains, profits or other income from the sale of intangible or real property located without the United States. Section 358(b) further provides that "in determining the source of income for purposes of this Section and Section 303(b), the provisions of Sections 861,

862, and 863 of the Internal Revenue Code of 1954 shall be applied." Since "source" is used only in connection with interest and dividends, these provisions are references for only these items.

Section 302 thus exempts from income taxation all income from intangible properties which consists of dividends from corporations in which the taxpayer owns 50% or more of the voting stock or of dividends attributable to "foreign sources" under Sections 861, 862, and 863 of the Internal Revenue Code of 1954. It also exempts interest other than interest derived from sources within the United States as determined under those sections of the Internal Revenue Code. Furthermore, it exempts other income from intangible properties defined in Section 358(a)(3) and income from the sale of intangible or real property located without the United States. Other than exemption of dividends from 50% owned affiliated corporations, Section 302 follows a pattern of specific allocation of various items of income in a manner which is contrary to apportionment principles.

3. Section 303 Restrictions on Combined or Consolidated Reporting. Section 303 contains limitations on combined or consolidated reporting. Subsection (a) of Section 303 provides that, except as otherwise provided in subsection (b), any state may require or a corporation may elect that the taxable income of the corporation be determined by reference to the combined or consolidated

net income and the combined or consolidated apportionment factors of all affiliated corporations in the affiliated group of which the corporation is a member. Subsection (b) of Section 303 provides that a state may not require that a combination or consolidation of an affiliated group include any excluded corporation or any corporation, substantially all of the income of which is derived from sources without the United States. If 80% or more of a corporation's gross income is derived from sources without the United States (as defined in Section 358(b) in the current taxable year and in each of the two preceding taxable years (excluding any period during which such corporation was not inexistence), substantially all of its income is deemed to be derived from sources without the United States.

Section 352 defines an excluded corporation as generally any financial institution, including a sales finance company, or any corporation which derives 90% or more of its gross income from interest (including discounts). An excluded corporation also includes any corporation that derives more than 50% of the ordinary gross income from transportation or public utility businesses. Affiliated corporations are defined in Section 353 as corporation which are connected through stock ownership with a common owner (corporate or non-corporate) through ownership of more than 50% of the voting stock

Section 302(c) further provides that "nothing in this title shall preclude the determination of combined or consolidated income on a basis acceptable to both the state and the taxpayer." The bill would thus exclude from a "combined report": D.I.S.C. corporations, captive financial subsidiaries and domestic subsidiaries which can be included in a consolidated return for federal income tax purposes.

4. Sections 354, 355, 356 and 357 Restrictions The Apportionment Formula Limitations. The apportionment formula, which prescribes the limits which cannot be exceeded by the states and their political subdivisions in attributing apportionable income, employs the equally weighted factors of property, payroll and sales. The denominators of the factors include the everywhere tangible property, payroll and sales of a corporation except as modified by the ambiguous language of Section 358(c) pertaining to excluded "foreign source" income. The numerators are limited to property, payroll and destination sales attributable to the taxing states. The sales factor does not eliminate from the denominator sales to jurisdictions in which the corporation is not taxable, nor does it come under the so-called "throw out" rule which would attribute these sales to the state or origin by the so-called "throwback" rule as does UDITPA, the Uniform Division of Income for Tax Purposes Act, which has been adopted by a majority of the income tax states. Thus, such sales would create pockets of income, which would not be taxable by any

method, i.e. "nowhere income". Inasmuch as the apportionment formula does not provide for full accountability of apportionable income and does not provide for the apportionment of all the unitary income of a unitary trade or business, it is patently defective.

B. Analysis of the Operative Effect of the Restrictions on the States and Their Political Subdivisions' Power to Impose Net Income Taxes on Multistate-Multinational Businesses. We incorporate here by reference our statement in regard to S. 1688 as a response to the exemption of dividend income and the limitations on "combined reporting" by Title III of S. 983. In addition thereto, we offer the following comments on Title III of S. 983. This title's provisions can be realistically viewed only as a blatant attempt by large complex domestic multinational corporations to exempt large blocks of their total net income from any state and local taxes on or measured by net income. In some cases all of a corporations substantial net income would be immunized. The corporation can hope to succeed in this attempt only by disguising the full impact of these provisions when tested against their ability to shift their profits throughout the world by ever increasing and complex "corporate shell games" and the use of tax havens in regard thereto.

The overall effect of the restrictions contained in Section 301, when coupled with the restrictions contained in other sections of Title III, is to exempt from taxation practically all of the income from stocks and from other intangible properties of large domestic multistate-multinational corporations which conduct their worldwide business activities through a host of subsidiary and affiliated corporations. It exempts from state and local taxation large blocks of income includable in taxable income for federal income tax purposes. Its apportionment restrictions prevent the states from taxing much other income. Furthermore, the bill prevents the states and their political subdivisions from viewing a multistate-multinational corporation and its affiliates as a single economic unit for tax purposes even though they conduct their worldwide activities as a single economic unit. We will here consider these exemptions separately.

1. Dividend Exemption. The exemption of dividends received from 50% owned corporations, the exemption of "foreign source" dividends and the attribution of all taxable dividends to the commercial domicile are not justified. There is no reason why the dividend income of a selected group of large multistate-multinational corporations should be exempt while the dividends of all other persons and businesses remain subject to tax. The

dividend exemption contained in Section 302 is premised on the false assumption that the ownership of stock in affiliated corporations is attributable to the underlying business activity of the affiliated corporations and not to the stock ownership of the parent corporation. If this were true, there would be no such thing as the taxation of dividends apart from the profits of the dividend payor corporations.

The exemption of dividends is inconsistent with the limitations in S. 983 on the power of the states and their political subdivisions to "combine" the income of the parent and the foreign and excluded affiliates from which the dividends are received. The exemption of dividends from affiliates which other dividends are taxed can be justified only on the basis that the parent and affiliates are treated as an economic unit that is operating a unitary trade or business. Under these circumstances, the income and the apportionment factors of such affiliated corporations and the parent corporations should be "combined". This is the only logical way of "sourcing" the income of such affiliated groups. But this bill would prohibit the application of the unitary business concept to the foreign and excluded corporations. This should not be allowed to happen.

In no event should multistate-multinational corporations be allowed to rely on the separate entities of their affiliated corporations to prevent the ascertainment of their true income and the proper apportionment of that income by a combined or consolidated report which at the same time being allowed to rely on their relationships with those affiliates as a basis for exempting dividend income received from the affiliates. Nor is there any reason to attribute taxable dividends to the commercial domicile under circumstances wherein stock acquisitions and the receiving of stock dividends are integrated with the overall business activities of the taxpayer corporation. In fact, in light of the Supreme Court decision in *Mobil v. comn. of Vermont*, No. 78-1201, dec'd March 19, 1980, it is doubtful whether the commercial domicile could constitutionally tax in full the dividend income of a unitary business.

2. *"Foreign Source" Income Exemption*. In addition to exempting dividend income from domestic affiliated corporations and attributing taxable dividends from United States "sources" to the commercial domicile, Sections 301 and 302 exempt from taxable income any "foreign source" income. Section 358 (b) defines "foreign source" income as income attributable to foreign sources under Sections 861, 862, and 863 of the Internal Revenue Code of 1954, as amended. Neither the classification of income as "foreign source income" under the provisions of Sections 861, 862 and 863 of the Internal Revenue Code nor the

Treasury Department's implementation of those provisions has anything to do with the determination of taxable income of United States domestic corporations and their worldwide owned and controlled affiliated corporations. Standing alone, apart from other provisions of the Internal Revenue Code, they have limited application. They are significant only for tax credit purposes for domestic United States corporations. It is not reasonable or logical to rely on these provisions to exempt income of United States domestic corporations from either state, federal or local taxes. Income classified as "foreign source" under Sections 861, 862 and 863 is not exempt from federal income tax under the Internal Revenue Code. The income defined in Section 358 of the bill as foreign source income is part of the federal taxable income of United States domestic corporations. Furthermore, the sourcing rules set forth in Sections 861, 862 and 863, to the extent relevant for federal income tax purposes, are policed by many other provisions of the Internal Revenue Code which can materially alter the "sourcing" of income under Section 861, 862 and 863. The Subpart F provisions are one example of this.

Federal income attribution rules for federal income taxes are simply not relevant for state and local income tax purposes. While the income defined in Section 358 may be labeled "foreign source" income for Internal Revenue purposes, such labeling is dependent entirely upon the attribution rules to be followed to determine what constitutes foreign source income. The Treasury Department uses specific allocation to determine foreign source income. That approach is inconsistent with the apportionment provisions of Title III and with the apportionment method utilized by all the states. In utilizing the apportionment method, the states "source" business income on the business income on the basis of the corporation's activities as represented by the location of its property, payroll and sales. This bill is totally defective in attempting to superimpose on state income attribution rules those rules set forth in Sections 861, 862 and 863 of the Internal Revenue Code. A multistate-multinational corporation is not entitled to the cumulative benefits of both attribution systems; particularly when these benefits are couples with dividend exemptions and restrictions against "combined reporting".

The difference between state apportionment rules and federal allocation rules can be illustrated by a comparison between Regulation 1.861-7 of the United States Treasury Department and the apportionment provisions of the bill. Under the regulation, gains, profits and income derived from the purchase and sale of personal property are treated as being derived entirely from the country in which the property is sold. Thus, if a corporation purchases property in the United States and sells it in Germany the income from the sale would be attributable to Germany. However, these same receipts would be attributable to Germany for apportionment purposes in accordance with the sales factor contained in Section 357 of the bill. The same is true of any property or payroll attributable to Germany under Sections 355 and 356 of the bill. Thus, the bill ignores the fact that the apportionment formula contained in Sections 355, 356 and 357 of the bill, unlike the specific allocation provisions of Sections 861, 862 and 863 of the Internal Revenue Code, is premised on the proposition that corporate income is derived from sources where the corporation carries on its income-producing activities, as represented by the formula factors.

3. "Combined Reporting" Restrictions. There is no reason why the states and their political subdivisions should not be able to require a consolidated or combined report for all members of an affiliated group which are conducting an integrated unitary business as a single

economic unit. The exclusions of any members of an affiliated group from the combined or consolidated report requirements, as provided for in Section 393 of the bill, constitute artifical restrictions on the unitary concept. These restrictions are predicated on the false assumption that the states can make arms-length pricing adjustments and other "policing" adjustments between corporations carrying on a unitary business as permitted by various provisions of the Internal Revenue Code. They are also based on "foreign source" allocation concepts which are alien to the apportionment method of sourcing income which is universally utilized by all the states. Why should a wholly owned sales subsidiary of a United States parent corporation be excluded from a combination report simply because 80% or more of its income is attributable overseas because title to the property was transferred overseas? No is there any basis for excluding corporations such as captive financial corporations of retailing parents from the combined or consolidated reporting requirements.

VI. TITLE IV - JURISDICTION OF FEDERAL COURTS.

Section 401 gives the Court of Claims jurisdiction to review de novo any issues relating to a dispute arising under the bill or under Public Law 86-272 as amended.

Section 402 makes a Court of Claims determination binding for the taxable years involved on any state which has been given notice or appeared as a party, notwithstanding any prior determinations of the courts or administrative bodies of that state completed after notice to that state. It further provides that no statute of limitations shall bar the right of a state or a corporation to an amount of tax increase or decrease in accordance with the determination of the Court of Claims, provided action is begun within one year after the determination has become final. It is highly questionable whether the states should give jurisdiction over their tax matters to the Court of Claims rather than their own courts. Even if such a centralization of litigation jurisdiction were to be established, however, certainly it should be a specialized tax unit, the branch of which should be state and local tax experts.

VII. TITLE V - MISCELLANEOUS PROVISIONS.

Section 501 prohibits out-of-state audit charges. Section 502 pertains to liability with respect to unassessed taxes. Its provisions are self explanatory. They are unduly restrictive in prohibiting the states and their political subdivisions from assessing net income taxes, gross receipts taxes or sales and use taxes for a period prior to the effective date of the bill. Because of the substantial change in the jurisdictional rules pertaining to sales and use taxes and gross receipts taxes and other substantial changes pertaining to the assessment of gross receipts, income taxes and sales and use taxes, this section is unjustified and arbitrarily restrictive.

VIII. GENERAL COMMENTS ON S. 983.

As this analysis indicates, S. 983 contains many arbitrary, highly restrictive provisions for the imposition of the various taxes to which it would apply. It creates vast areas of tax exemptions, immunities and preferential treatment for multistate-multinational corporations. It would prevent the states and their political subdivisions from requiring multistate-multinational corporations to pay their fair share of state income taxes. The bill does not simplify state tax administration or relieve multistate-multinational corporations from undue compliance burdens. It simply superimposes, without rhyme or reason, arbitrary restrictions on existing state and local taxing powers. The bill should be totally rejected by this committee.

STATEMENT OF WILLIAM D. DEXTER
GENERAL COUNSEL OF
THE MULTISTATE TAX COMMISSION
FOR THE MULTISTATE TAX COMMISSION
IN THE HEARINGS BEFORE
THE FINANCE COMMITTEE
OF THE UNITED STATES SENATE
JUNE 24, 1980
ON S. 1688

I. INTRODUCTORY STATEMENT

The Multistate Tax Commission, composed of nineteen regular member states and twelve associate member states, unequivocally opposes S. 1688. This bill unjustifiably and artifically limits the employment of the unitary concept for state income tax purposes. In addition, it unjustifiably exempts from state and local income taxation substantially all of the "dividend" income of large multistate-multinational corporations. The bill permits the corporate shell game to control for state and local income tax purposes, so long as the profits of multinational corporations are shifted to or are attributable to overseas operations and returned in the form of dividends, multinational corporations will enjoy a tax-free ride for state and local income tax purposes. Any such bill would destroy the tax and fiscal integrity of the states and their political subdivisions.

In the case of Mobil Oil Corp. vs. Commissioner of Taxes, (Supreme Court of the United States Docket No. 78-1201, dec. March 19, 1980) restrictions on the unitary concept and exemptions of dividends, as provided for in S.1688, would have exempted Mobil Oil Corporation from any state and local income taxes whatsoever for the years of 1971 and 1972 and would have exposed Mobil to only minimal state and local income taxes for the year 1970. However, the Supreme Court found that, by appropriate application of the unitary concept, the inclusion of Mobil's "foreign source" dividends in apportionable income for Vermont income tax purposes did not amount to the taxation of the "foreign source" income of Mobil.

For state and local income tax immunity and preference purposes, the dual restrictions of S. 1688 go hand in hand. For example, parent domestic corporation A forms domestic subsidiary B. to sell A's products in a foreign market. Under S. 1688, if the title to the property which is the subject of these overseas sales is transferred outside the United States, the gross income of B could not be taken into account in determining the amounts of state and local income taxes imposed on A. Furthermore, the profits of

B returned to A in the form of dividends could not be taxed to A. This would leave corporation A free to funnel its profits to its sales subsidiary, B, and insulate those profits from any significant state and local income taxes, subject only to the states' and their political subdivisions' ability to apply the "arm's" length" test or other equally elusive standards. Even these standards would be inapplicable if B were merely a DISC shell to the extent that the IRC arbitrarily allows profits to be attributable solely to the DISC which then issues or is considered to have issued dividends.

An actual example is the corporate shell game played by amajor domestic oil corporation. This corporation translated internal domestic sales into international sales of its foreign affiliated corporations. It accomplished this result by a paper transfer of its domestic crude oil to its foreign subsidiaries in the course of the movement of the crude oil in its tankers on the high seas from its domestic production fields to its domestic refineries in the United States. Yet another actual example is the multiple intercorporate transfers of wheat by a large multinational grain company. Through a series of sales to its foreign subsidiaries, this company was able to attribute its domestic profits from eventual overseas sales to "foreign sources."

Additional examples of why S. 1688 restrictions on the unitary concept are unacceptable to the states are two pertaining to the utilization of "tax haven" countries by multinational corporations to attribute their profits to so-called "foreign sources" and thus place them beyond the reach of the states for apportionment purposes. The cases are: Dittler Brothers, Inc. v. C.I.R., Tax Court Docket No. 5438-78T, 72 TC ____, No. 77, filed August 27, 1979 (CCH Tax Court Reports, Dec. 36,266); and U.S. Steel Corp. v. Com., U.S. Court of Appeal, 2nd Circuit No. 79-4092, decided 3/12/1980.

Dittler Brothers, developed a secret patent in the United States and using that patent and its own manufacturing know-how, the company produced heavy income, but it attributed that income to a subsidiary operating in tax haven country. The IRS was unsuccessful in attacking their subterfuge. U.S. Steel likewise was able to insulate from taxation large amounts of income from its integrated steel operations by attributing to a tax haven the income from its shipping operations. In U.S. Steel and Dittler there can be little question that the taxpayers, by the "corporate shell game" were able to shift profits to "foreign sources" which in a true economic sense were derived primarily from their domestic operations. However, in both instances, corporate form rather than business and economic reality were given controlling significance. The recent "Offshore Tax Havens" hearings before the Subcommittee on Oversight of the Committee of Ways and Means of the House of Representatives, 96th Congr., 1st Sess., Serial 96-26, April 24, 25, 1979, provide some interesting insight into tax haven matters.

The corporate shell game cannot be accepted by the states as being of controlling significance for state income tax purposes. But S. 1688, would impose it upon them. It would do so by restricting the application of the unitary concept and by exempting claimed "foreign" profits when those profits are eventually received by United States corporate taxpayers in the form of dividends.

The states cannot equitably and efficiently impose their income taxes on all segments of the business community if the corporate form of multinational businesses and the artificial control of inter-corporate dealings among affiliated corporations are determinative for state and local income tax purposes. In our judgment, it should make no difference in what form the profits of multinational corporations are received by the parent or whether the parent chooses to conduct its worldwide business operations under a single corporate umbrella or under a group of corporate umbrellas.

S. 1688 deals with three distinct subject matters which require distinct and separate consideration by this committee. They are:

(1) Restrictions on the application of the unitary concept as applied to foreign parents conducting operations in the United States through subsidiary corporations;

(2) Restrictions on the application of the unitary concept as applied to domestic parents conducting business in foreign countries through subsidiary corporations;

(3) The exemption of "dividends."

The arguments advanced for not applying the unitary concept to the domestic subsidiaries of a foreign parent are generally irrelevant in deciding whether the unitary concept should be applied to the foreign subsidiaries of a domestic parent. Foreign governments and their domestic corporations are not concerned with how the United States deals with its own domestic corporations. Furthermore, there is a vast difference between determining what part of a foreign parent's total income should be attributable to United States "sources" and what part of a domestic parent's worldwide income should be attributable to United States sources. Thus, to treat (1) and (2) above as the opposite sides of the same coin is highly misleading. There is a vast difference between attributing the body (the foreign parent corporation) of an octopus to one of its tentacles (a subsidiary in the U.S.) and attributing one of its tentacles (a subsidiary in a foreign country) to its body (the U.S. parent). Foreign governments determine how to tax the profits of their corporate parents, which are foreign parents from the U.S. perspective; but their decisions should not determine how we determine the tax liability of U.S. corporations.

II. ANALYSIS OF THE SPECIFIC PROVISIONS OF S. 1688

S. 1688 would add a new section (§7518) to the miscellaneous provisions of the Internal Revenue Code (I.R.C.) of 1954, as amended. Subsection (a) deals with the issue of "combined reporting." Subsection (e) deals with the subject matter of exemption of dividend income. While the subsection (a) restrictions are interrelated with the subsection (e) dividend exemptions, we will deal with them separately for purposes of analysis.

A. Subsection (a) restrictions on state and local taxing powers

The section prevents requiring that a corporation subject to state and local income taxes file a combined report which takes into account activities of "foreign corporations" as defined in the bill. Subsection (a) would prevent the states and their political subdivisions from taking into account, in determining income tax liability of any corporation, the gross income of "foreign corporations" as defined in the bill unless it is includable in the gross income of the taxpayer corporations under Chapter 1 of the I.R.C. Thus, if a state income tax law would include the income of such a "foreign corporation," in the gross income of any corporation for state income tax purposes, that state law would be invalidated by paragraph (a) unless the gross income constituted includable gross income of the corporation under Chapter 1 of the I.R.C.

If the provisions of subsection (a) coupled with subsection (d) are designed to prevent any foreign corporation and any domestic corporation deriving more than eighty percent of its income from "foreign sources" under the Internal Revenue Service's income source attribution rules from being "combined" with any corporation for purposes of state and local income taxes, it is questionable whether they achieve this result.

Subsection (a), in employing the phrase "includable in gross income of such corporation for purposes of Chapter 1" would apparently require the states to examine all of the provisions in Chapter 1 of the I.R.C. to determine the gross income of any corporation which has dealings with foreign corporations as defined in the bill. Ostensibly, then, the state would be empowered to employ the provisions of §482 of the I.R.C., which, as administered by the Internal Revenue Service, employ both the "arm's length" standard and elements of the unitary business standard [See Note, "Multinational Corporations and Income Allocation under §482 of the Internal Revenue Code," 89 Har. L. Rev. 1202 (1976)] to determine what is includable in the "gross income" of a corporate taxpayer in its dealings with its "foreign corporations." However, a "combined report" does not adjust the "gross income" of affiliated corporations included in a combined report. Rather, it combines the net income of the members of the affiliated group included in the combined report (eliminating intercorporate transactions) and apportions income according to the combined apportionment factors of the members of the affiliated group included in the combined report. Therefore, how the restrictions on "gross income" contained in subsection (a) of S. 1688 affect the validity of a "combined report", particularly when coupled with the provisions of $482 of the I.R.C. and other attribution provisions contained in Chapter 1 of the I.R.C., is unclear.

We also note that subsection (a) coupled with subsection (d) requires a corporation to be treated as a foreign corporation even though under state attribution rules the entire income of the corporation is attributable to domestic sources and activities. This follows from the difference between federal source concepts and state source concepts for income attribution purposes. For example, the sales of a DISC corporation would be attributable to United States sources under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) if sales were made to a foreign country in which the DISC corporation is not taxable. However, under federal attribution rules if title to the products sold by the DISC is transferred outside the United States, one hundred percent of the DISC income would be attributable to "foreign sources." This is just one example of the lack of any congruence between federal "separate accounting" and source principles as compared to the apportionment of unitary income followed by the states.

Furthermore, subparagraph (b) defines an income tax for purposes of the bill as any tax on or measured by income. This apparently would embrace gross receipts taxes as well as franchise taxes measured by gross receipts or gross income. It might well also embrace general sales and use taxes, many of which could be construed to be imposed on, according to, or measured by income. If S. 1688 is intended to be limited to net income taxes, the definition of income tax in subsection (b) is defective.

It should also be noted that subsection (a) does not impose any restrictions on any corporation. Thus, any corporation can employ unitary concepts, including "combined reporting," for state and local income tax purposes, even though the states would be restricted in that respect.

It also should be noted that subsection (a) restrictions apply to corporations which may be entitled to file a consolidated report for federal income tax purposes. Clearly, the consolidated return provisions of the Internal Revenue Code embrace domestic corporations defined as "foreign corporations" in subsection (d) of S. 1688.

In sum, it is difficult to know exactly what would be accomplished by the enactment of subsections (a) through (d) of S. 1688. To our knowledge, there is nothing contained in Chapter 1 of the I.R.C. which would preclude the use of combined reporting or the unitary concept in determining the tax liability of a group of corporations even though there is included in such a group so-called "foreign corporations" as defined in the proposed bill. §482 of the Internal Revenue Code, specifically provides as follows:

> "In case of two or more organizations, trades, or business (whether or not incorporated, whether or not organized in the United States) and whether or not affiliated (owned or controlled directly or indirectly by the same interest) the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly reflect the income of any such organizations, trades, or businesses."

This language would appear to embrace the "combined reporting" unitary concept. As noted in the Harvard Law Review referred to earlier, "* * * The most recent Congressional action regarding §482 indicates that Congress considered use of the unitary entity theory more appropriate for §482 allocations between U.S. businesses and their foreign affiliates." (89 Har. L. Rev. 1211)

B. Subsection (e), restrictions on the power of the states and their political subdivisions to tax dividend income

Subsection (e) of S. 1688 exempts dividends from any state or local income taxes which are deductible pursuant to §243 of the I.R.C., and those dividends eliminated in a consolidated report under I.R.C. §1502. By reference to §951 of the I.R.C. in subsection (e) there is also excluded Subpart F. income. These dividend exemptions pertain to domestic corporations.

In addition, under subsection (e), dividend income from foreign corporations is exempt from state and local taxation to the extent that foreign withholding taxes on the dividend income and deemed paid taxes equal or exceed forty-six percent of the dividend income, that amount of dividend income from foreign corporations would be subject to tax. This dividend exemption in subsection (e) is not limited to the actual taxes paid to foreign governments by the taxable corporation on its dividend income. Neither is it limited to the actual amount of foreign tax credit in fact allowed any corporate taxpayer for federal income tax purposes. The dividend exemption is applicable even if the taxpayer does not elect the foreign tax credit. The dividend exemption is also permitted even though the tax credit is not allowed because of the limitations contained in section 904 of the I.R.C., which are highly significant. As we read the Internal Revenue Code, if corporation A received $1,000,000.00 in dividend income from foreign affiliated corporations and suffered a $1,000,000.00 loss as a result of other foreign operations, the corporation would be entitled to no foreign tax credit since the credit is computed against the aggregate of its "foreign source" income which is included in federal taxable income. Thus, subsection (e) is simply directed to hypothetical and abstract considerations not tied to the actual federal income tax credit in fact allowed corporations in regard to dividends received from foreign corporations. There is no congruence between subsection (e) for the credited taxes provided for therein and any actual tax credit a corporation is entitled to for federal income tax purposes. It is thus highly misleading for proponents of S. 1688 to assert that subsection (e) parallels any policy of the federal government in eliminating any alleged double taxation of so-called "foreign source" income received by a domestic corporation as dividends.

III. COMMENTARY ON S. 1688

A. The limitations of subsection (a) of S. 1688

For purposes of our commentary, we assume that subsection (a) is designed to prevent any foreign corporation or domestic corporation that derives less than twenty percent of its gross income from sources within the United States under federal income tax source rules from being included in a combined report of any corporation. For example, if any corporation formed a subsidiary corporation such as a DISC, for its overseas sales and if title on the sale of its products was transferred outside this country, the parent and the sales subsidiary could not be combined for state income tax purposes even though both are domestic corporations. Subsection (a) is a restriction on the states and their political subdivisions, but not on corporation; any corporation remains free to use worldwide combined reporting by application of the unitary concept to determine its liability for income taxes to any state or any political subdivision thereof.

The important question for this committee is Why should Congress prevent the states from using the unitary method in determining income attributable to instate sources and activities of a corporation that conduct a unitary trade or business with its affiliated corporations? The Task Force on Foreign Source Income of this committee in its Recommendations (95th Congress, 1st session, March 8, 1977) considered the question of state taxation of so-called "foreign source" income. In comment on "limitations on the unitary method of apportionment" the Task Force noted that:

> "For Federal income tax purposes, an apportionment formula is not used to divide income and costs between the United States and foreign countries. Instead, income and costs are allocated between related companies using the criterion of what the costs and prices would be between these parties if they were independent parties dealing at arm's length (Sec. 482). On the other hand, in computing what portion of the income of a single company is from foreign sources, an allocation of income and deductions approach is used (Sec. 861). This approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the states must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).
>
> "The rationale presented for using the unitary method to combine the business activities of related corporations which contribute to the business activities of a corporation within a taxing State is that the operations form an integrated business, and whether the business is conducted through a number of separate corporations or through one single corporation should not affect tax liability.
>
> "It is disputed whether those States applying the unitary method of taxing corporate business income under an apportionment formula do, in fact, tax the income related foreign corporation. * * *"
> (Recommendations of the Tax Task Force, pp. 27-28)

However, the task force recommended,

> "* * * that the States be precluded from taking into account, under the unitary method, or any other method, the income of foreign affiliates of corporations doing business within the State until such time as that income is subject to Federal income tax."
> (Recommendations of the Tax Task Force, p. 30)

The Task Force recommendations did not include domestic corporations which are included in subsection (a) of S. 1688 by reference to the definition of foreign corporations contained in subsection (d). The Task Force on foreign source income advanced no reason for denying the unitary principle to the States as pertains to foreign affiliates of domestic corporations. The Task Force did indicate that there were accounting problems connected with a foreign parent conducting operations in the United States through a subsidiary corporation. The Task Force really did not address itself to the underlying question of whether or not the unitary method was more appropriate and more workable for state income tax purposes than separate accounting (the arm's length standard).

If Congress is to require the states to use "separate accounting" rather than the unitary method, it should address itself to the relative merits of the two methods for state income tax purposes. In doing so, it should clearly differentiate "combined reporting" for a domestic parent from "combined reporting" for the subsidiary of a foreign parent. As far as the states are concerned, "separate accounting" is just as unworkable for them at the international level as it is at the interstate level.

The merits of the "arm's length" or "separate accounting" methods as compared to the unitary method, in the context of Article 9(4) of the United States - United Kingdom tax treaty (reserved from that treaty by the Senate), were the subject of a debate set forth in Articles in a special report of "Tax Notes" Vol. VI, issue 16, dated April 17, 1978. Inasmuch as we believe that these Articles fairly set forth the arguments on both sides of this issue in the context of state income taxes, these Articles are appended to and made a part of this statement. In addition, there is appended hereto and made a part of this statement the doctorial thesis of Geoffrey Harley, prepared by him for his doctorate degree in Law from the University of Michigan Law School, Ann Arbor, Michigan. This thesis contains an exhaustive analysis of the relative merits of the Section 482 arm's length method and the unitary method for the attribution of income. It is undoubtedly the most comprehensive analysis of this subject matter available to date.

As we understand the argument of the proponents of "separate accounting," they are primarily concerned with two issues. The first issue is the distortion which they claim results from applying a single apportionment formula to the worldwide income and worldwide business activities of a group of commonly owned and controlled affiliated corporations. Secondly, they are concerned with the

administrative and compliance burdens posed by this application of the unitary concept. In advancing their first argument, they fail to realize that any distortion in the apportionment factors exists to exactly the same degree and extent whether the worldwide operations of a business are conducted in a single or in a multiple corporate form. In advancing the second argument, the proponents of the arm's length standard fail to note that application of the arm's length standard is much more complex and difficult than is the application of the unitary concept. Even the U.S. Treasury with its vast resources cannot make the arm's length method work. This follows from the fact that it is simply not possible to ascertain which profits of an integrated unitary business are attributable to its inseparable parts. The "arm's length" standard involves guesswork based upon hypothetical "but for" facts. That is why the IRS constantly resorts to unitary concepts in making §482 adjustments. As noted by the Supreme Court of the United States in Underwood Typewriter Company v. Chamberlain, 245 U.S. 113 (1920), "it is impossible to segregate the profits attributable to each operative level of an integrated unitary business." Furthermore, the courts have never held that accounting should control tax liabilities (Thor Power Tool Company v. Commissioner, ____U.S. _____ 99 Sup. Ct. 773 (1979); Butler Brothers v. McColgan, 315 U.S. 501 (1942); Mobil v. Comm'r of Taxes of Vermont, Sup. Ct. No. 78-1201, dec'd March 19, 1980).

Even if we assume that the arm's length standard is workable at the Federal level, that provides no reason for assuming that it is workable at the State level. Most of the state income tax statutes have provisions which permit arm's length adjustments. However, the states have not relied on those provisions because of the difficult administrative and compliance problems involved. It is one thing for the federal government to employ a certain standard in reference to its high rate income tax in order to determine the total taxable worldwide income of domestic corporations. It is quite another thing for the states to apply the same standard in reference to their low rate taxes which can reach only a small segment of that income and which are deductible for federal·income tax purposes. Inasmuch as state income taxes are in addition to and stand apart from any federal income taxes and since as the states are confined by narrow jurisdictional tax limit time, there is no known reason why a federal standard should be applied to state income taxes. This is particularly true in regard to domestic U.S. corporations and their domestic affiliates.

Certainly, the examples and arguments pertaining to "combined reporting" of a domestic subsidiary of a foreign parent should not be used indiscriminately to preclude combination of a domestic parent with its foreign subsidiaries. Yet, S. 1688 would prevent the states from applying the unitary concept to domestic corporations which are entitled to file a consolidated federal income tax return. Any Congressional consideration of mandating the arm's length standard for state income tax purposes should clearly distinguish between foreign parent corporations doing business in the United States through subsidiary corporations, domestic parent corporations doing business outside the United States through foreign subsidiary corporations, and domestic parent corporations doing business attributable to overseas sources by IRS attribution rules through domestic subsidiary corporations. While there is no valid reason for the "arm's length" standard to be mandated by Congress for any of these affiliated groups for state income tax purposes, its application to each group merits separate consideration. Policy considerations for one group may not be applicable to the other groups.

For example, What justification exists for prohibiting the states from combining a domestic DISC corporation with its domestic parent when they are conducting an integrated unitary business? Yet, subsection (a) would prevent such a "combined report."

Nor is there any merit to the argument of double international taxation of the income of foreign corporations. Within our federal system there is always double taxation of the income of corporations. It is taxed at the federal level, and Also, at the state level and even at the political subdivision level. In the view of the proponents of S. 1688, this alone presumably constitutes impermissable double taxation. Any such double taxation argument is based on the idea that the states subject to taxation the identical income which is subject to tax at the federal level. This of course is not true. Net income for state tax purposes is different from net income for federal income tax purposes. The tax bases are not the same. The attribution rules are not the same. Since the states are not taxing the same net income as is taxed at the federal level, since the state taxing systems are in addition to the federal system, and since the two systems employ different income "source" and attribution rules, what possible justification is there for requiring the same methods to be used by the federal government and the state governments in applying division of income rules?

In sum, no legitimate overriding federal policy which is embraced in the restrictions contained in subsection (a) of S. 1688. It embraces not only foreign corporations, butdomestic corporations as well to the extent that federal sources rules (which are entirely different than those of the states) attribute more than eighty percent of the income of a domestic corporation to "foreign sources." Any such restriction on state taxing powers simply lets large multinational corporations play the "corporate shell game" without restriction. It permits their "separate accounting" to control for state income tax purposes. However, "separate accounting" has been repeatedly rejected by the Supreme Court. Butler Bros. v. McColgan, supra, Mobil Oil Corp. v. Commissioner of Taxes, supra. Above all, "separate accounting" should not be mandated by Congress for the states unless it finds three things: first, that "separate accounting" is superior to the unitary concept for state income tax purposes; second, that there is some compelling federal policy reason why Congress should dictate the method or methods used by the states in attributing the income of multistate-multinational corporations to instate activities and sources; and third, that the IRS cannot apply unitary principles under provisions of the I.R.C. Since there is no valid reason why "separate accounting" should be preferred over the "combined reporting" unitary method; since there are no overriding federal policy considerations which dictate that state income tax law should conform to federal income tax law for income attribution purposes; and since there is no reason why the I.R.C. as presently written does not allow "combined reporting;" the subsection (a) restrictions of S. 1688 lack merit.

While arguments in favor of such restriction may be advanced in reference to "international double taxation," the fact of the matter is that state income taxation has not been demonstrated to reach total federal taxable income.

Also, state income taxes are always in addition to federal income taxes. Therefore, any claim of double taxation falls on barren ground.

B. Section (e) restrictions of S. 1688

As heretofore indicated, subsection (e) of S. 1688 is tantamount to the complete exemption of dividend income of multistate-multinational corporations even though the dividends exempted by its provisions are a part and parcel of federal taxable income for federal income tax purposes.

The complete exclusion of dividends which are deductible under §243 of the Internal Revenue Code as "special deductions" and dividends eliminated from a consolidated group in accordance with §1502 of the Internal Revenue Code are geared, under the Internal Revenue Code, to very different circumstances than those pertaining to state taxation of dividend income. First, if corporations file a combined report or a consolidated report for state income tax purposes, these dividends would automatically be eliminated from any state income tax base. Second, the justification for the dividend deductions provided by §243 is not germane to state tax purposes except where a particular state taxes the underlying profits of a subsidiary or affiliated corporation and in turn taxes the dividends from those already taxed profits as part of the income of the payee corporation. This follows from the fact that the special dividend deduction allowed by §243 of the Internal Revenue Code is premised upon the proposition that the federal government has already subjected to tax the earnings and profits of the dividend payor corporations. This is not true in regard to any state income taxes except to the extent that the earnings and profits of the payor corporation have been in fact subject to tax by the taxing state. If the underlying rationale of §243 were to be applied appropriately to state income tax laws, the only dividends which would be excluded from taxation to the payee corporation would be those dividends which came from profits of the payor corporation which had been taxed previously by the taxing state. Under this rationale, if a parent corporation did business in California, and if its subsidiary corporation conducted forty percent of its business in California, and if, therefore, only forty percent of the subsidiary's income were apportioned to California, only sixty percent of the dividend income of the parent should be included in apportionable income by California. This is precisely how California law operates.

On the other hand, if a parent corporation in California had a subsidiary corporation that does business entirely outside the state of California, California should include all of the dividends in its tax base subject to allocation and apportionment. This is what California does.

Thus, the California rule follows precisely the federal rule contained in §243 modified to conform to the limited jurisdiction of the State of California. , California, in requiring a combined report, would also eliminate the interaffiliate dividends from income for purposes of this report. Again, California law would then coincide with the federal law as pertains to the elimination of intercorporate dividends by federal consolidated reporting. In sum, even if state law had to conform precisely to the philosophy and policy of the federal government in regard to domestic dividends, we submit that the subsection (e) exemption of domestic dividends, would be totally unjustified.

In addition to exempting domestic dividends, subsection (e) exempts dividends received by any corporation from foreign corporations in the ratio in which the numerator is the amount of withholding taxes paid on the dividends plus taxes deemed to be paid on the underlying profits of the foreign corporations from which the dividends are paid and in which the denominator is 46% of the dividends so paid. Presumably, this proportionate dividend exclusion is intended to eliminate and exempt from state taxation the dividend income which in substance has not been subject to federal income tax by operation of the federal tax credit provisions contained in §§901-904 of the I.R.C.

Laying aside for the moment the fact that federal tax credits have nothing to do with state income taxation, it is to be noted that the dividends excluded by subparagraph (e)(1)(B) and (2) of S. 1688 are not those dividends which in fact escape taxation by the federal government because of tax credits allowed by §§901-904 of the I.R.C. The credit on which the dividend exemption of subsection (e)(1)(b) is based is determined without regard to the limitations contained in §§901-904, particularly §904. This means that dividends are excluded even though they are in fact taxed by the federal government without any offsetting credit. As noted earlier, if a domestic corporation received $1,000,000.00 of dividend income from its Canadian subsidiary, and if by operation of other provisions of the Internal Revenue Code, it had "foreign source income" losses of $1,000,000.00, no tax credit would be allowed against the dividend income for federal income tax purposes (§§904, 862, and 863). However, since subsection (e) of S. 1688 is not geared to actual tax credits, the $1,000,000.00 of the dividend income in this example would be exempt from state income taxation under subsection (e)(1)(B) in the ratio that the foreign and deemed paid taxes bear to $46,000. Furthermore, since subparagraph (e)(2) refers to hypothetical circumstances, the dividend exemption there set forth would be available even though the foreign taxes were taken as a deduction by the domestic corporation and even though no credit were applicable on even a theoretical basis. Assuming arguendo that the dividend exclusion contained in subparagraph (e)(1)(B) and (2) of S. 1688 was limited to the real world of federal tax credits, this dividend exemption from state income taxation would still be unjustified.

Under the federal tax laws, the entire net income of a domestic corporation, whether received from foreign or domestic "sources," is subject to federal income tax. For that reason, as a matter of policy, in order to avoid duplicate taxation at the national level of earnings attributable to sources outside the United States under the I.R.C. as administered by Treasury, the federal government allows a foreign tax credit (if elected in lieu of a deduction) for foreign taxes paid directly by domestic corporations (IRC §901). For similar reasons, the Federal government allows a United States corporate taxpayer receiving dividends from a foreign corporation in which it holds a ten percent or greater stock interest an "indirect" or "deemed paid" credit for a proportionate share of foreign income taxes paid on the underlying earnings of a foreign subsidiary out of which the dividends are paid (IRC §902). In particular, foreign tax credits may not exceed the amount of the Federal income tax imposed on the corporation's "foreign source" income as determined under §§862 and 863 of the Internal Revenue Code.

Such provisions are relevant to avoid duplicate taxation of the entire worldwide income of a domestic corporation at the national level. They are irrelevant to an apportioned state net income tax which by definition reaches only earnings fairly attributable to a corporation's activities within the borders of the taxing state. These provisions were not intended to preclude, and have never been interpreted as precluding, a properly apportioned net income tax at the state level.

Furthermore, the provisions of the Internal Revenue Code dealing with the classification of income from sources within or without the United States cover not only dividends but virtually all forms of income, including interest, rents, royalties, compensation for services, and sales income. (See IRC §§861-863) If there is any validity in the argument, in justification of subsection (e)(1)(B) and (2), that the federal policies underlying the foreign tax credit require that "foreign source" dividends receive special state tax treatment, then it is difficult to see why special rules would not also be dictated for all other income treated as "foreign source" for Federal income tax purposes. As noted by the Supreme Court of the United States in its recent decision of Mobil Oil Corp. v. Commissioner of Taxes, supra, in rejecting Mobil's "foreign source dividend income" argument:

> "The same contention could be advanced about any income arguably earned from foreign commerce. If appellant's argument were accepted, state taxing commissions would face substantial difficulties in attempting to determine what income does or does not have a foreign source." (Slip op., p. 21)

Thus there is no merit for the singling out of dividend income in subparagraph (e) of S. 1688 for exempt treatment. Again, we turn to the Supreme Court of the United States decision in Mobil, wherein the court stated:

> "So long as dividends from the subsidiaries and affiliates reflect profits derived from functioning integrated enterprises, those dividends are income to the parent earned in a unitary business. * * *
>
> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries in separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. * * * Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." (Mobil Slip op., pp. 14-15)

As in subsection (a) of S. 1688, subsection (e) attempts to superimpose on existing state attribution rules those followed by the federal government. The fact is, however, that the states utilize very different attribution rules based upon very different constitutional and jurisdictional limitations. Federal income source rules which characterize some income of domestic corporations as being derived from "foreign sources" are not the same and cannot be correlated with or compared with state source rules. The federal government employs basically "separate accounting" while the states follow the practice of apportionment of the unitary income of a unitary business of a multistate-multinational corporation. This unitary concept is sought to be fractured not only by subsection (a) of S. 1688, but also by subsection (e). If subsection (e) were enacted into law it would in effect completely overrule Mobil Oil Corp. v. Commissioner of Taxes, supra, and require the dividend income there involved to be attributable to overseas "sources" by "separate accounting." The court in Mobil for due process and commerce clause purposes refused to "source" the dividend income from Mobil's foreign subsidiaries and affiliates to "sources" unrelated to Mobil's activities in Vermont since this dividend income was derived from and used by Mobil as part of its unitary worldwide trade or business operations. Again, in Mobil, the court noted:

> "Nor does federal tax policy lend additional weight to appellant's argument. Federal statutes and treaties that Mobil cites * * * concern problems of multiple taxation at the international level and simply are not germane to the issue of multiple state taxation that appellant has framed. Concurrent federal and state taxation of income, of course, is a well-established norm." (Mobil Slip op., p. 22)

IV. SUMMARY AND CONCLUSION

S. 1688 is badly drafted and ill-advised proposed federal legislation. It represents an unprecedented and unwarranted effort by multistate-multinational corporations to insulate their net income from any effective state and local taxation. S. 1688 would accomplish this result by outright exemption of dividend income by theoretical analogy to the federal treatment of dividend income for federal income tax purposes and by coupling such exemptions to Congressional restrictions on the ability of the states to apply their own reasonable apportionment standards for the division of income.

The Multistate Tax Commission and its member states have a vital interest in ensuring that all businesses which carry on activities within their jurisdictions and which benefit from their governmental services and functions bear a fair share of the public cost of these activities. This is not just a question of revenues which are vital to the states. It is a question of tax justice, as well.

In regard to corporate privilege taxes tax justice can be accomplished only by the reasonable apportionment of the income of a unitary trade or business carried on in part in the taxing state. It cannot be accomplished by reliance on the elusive, everchanging corporate structure and "separate accounting" of multistate-multinational businesses.

There is no federal policy or valid reason of which we are aware which requires that a net income tax base for federal income tax purposes be controlling for state and local income tax purposes. Nor, is there any reason why federal income tax attribution rules, which generally embrace "separate accounting" principles, should be mandated by Congress for state income tax purposes; especially in view of the universally recognized fact that the states lack the administrative capability of policing the "separate accounting" of multistate-multinational corporations adequately. Such administrative considerations constitute in part the reason why the states have universally adopted the apportionment principle rather than that of separate accounting. This principle, which requires full apportionment of the unitary income of a unitary trade or business, is the only feasible one for state and local use in resolving income attribution problems. In our judgment it is also superior in both method and result to that of "separate accounting." In any situation wherein application of the unitary principles produce unreasonable results, the corporate taxpayer is entitled to relief under every state law. Therefore, examples of distortions by the employment of the unitary principle are totally irrelevant. Nor can the distortions applicable to foreign parent corporations be logically carried over to domestic parent corporations.

The fact that the federal government, pursuant to its unlimited jurisdiction over the entire net income of domestic corporations and their controlled affiliated corporations, chooses to grant limited tax credits and chooses to employ "separate accounting" to differentiate between domestic source and foreign source income has no relevancy for state and local income tax purposes. The state tax system has always existed independent of and in addition to the federal income tax system. No taxes on or measured by net income (federal or foreign) have ever been credited against the low rate state income taxes.

The reasoning relied upon by the Supreme Court of the United States in Mobil, supra, in upholding the unitary method for "sourcing" income for state income tax purposes and in requiring the apportionment of Mobil's so-called "foreign source" dividend income, requires the rejection of S. 1688 by this Committee.

Even if one were to assume that S. 1688 is limited to exempting dividends which are exempted by the I.R.C. or which are subject to federal tax credits under the I.R.C., and even if one assumes that S. 1688 is limited to requiring federal income source rules to be used in determining what constitutes "foreign source income" for state and local tax purposes, there still is no valid reason why these exemptions and limitations should be applied to state and local taxes on or measured by net income.

Wherefore, it is respectfully submitted that this Committee should not approve S. 1688.

SPECIAL REPORT

ARTICLE 9(4) OF THE UNITED KINGDOM TAX TREATY SHOULD BE RESERVED

by William D. Dexter

William D. Dexter is General Counsel of the Multistate Tax Commission.

In this article he calls upon the Senate to kill Article 9(4) of the proposed United States–United Kingdom Tax Treaty, which would restrict the right to use the unitary method of taxing business income of UK corporations. Under the unitary method, states can tax their portion of a multinational firm's overall, worldwide profit, determined as a unit. The portion of the firm's overall profit that is allocable to the taxing state is determined by a formula, normally a three-factor formula that takes into account the firm's property, payroll and sales within the taxing state.

Not allowing the states to use the unitary method would force them to rely on a separate accounting for in-state operations, which, in turn, must depend on the arm's length method of pricing. According to Dexter, there is often no evidence of what an "arm's length price" for a product or service may be, either because there is no market, or because the product or service is unique. States do not have the resources necessary to audit multinational corporations under the separate accounting method, says Dexter, and they should not be forced to adopt an income allocation method that is beyond their capabilities.

Article 9(4) of the United States–United Kingdom tax treaty, which has been favorably reported by the Senate Foreign Relations Committee, poses issues which require far more attention than they have yet received.

One of the most difficult problems in the administration of state income taxes is that of determining how much of the net income of a multistate corporation is reasonably attributable to a particular state. This problem is compounded by the fact that most large corporate businesses operate through numerous subsidiary and affiliated corporations.

There are two basic methods for attributing corporate income among states. One method is commonly referred to as "separate accounting."[1] The other method is called "formula apportionment."[2]

Separate accounting can be used effectively only where the income producing activity of a business within a particular state can be clearly seperated from the income producing activities outside the state. Where a taxpayer conducts interconnected or "unitary" business activities both within and without the taxing state, separate accounting is inappropriate and produces fictitious and even whimsical results. Such unitary income should be subjected to apportionment in such cases.

Legal Development

The formula approach is now used by a majority of the states and often by the Internal Revenue Service. It evolved out of court decisions reaching back over 100 years. It was first applied by the U.S. Supreme Court in determining the property tax liability of interstate utilities.[3] These early utility property tax cases recognised the unitary nature of an interstate utility system and held that it was appropriate to use an apportionment formula to determine what portion of the value of that system was attributable to a particular state. The Court rejected the interstate utilities' efforts to limit property taxation to the value of the properties located in the taxing state, and treated as a single unit the group of corporations which constituted the integrated utility system.[4]

This so-called "unit rule" was first applied by the Supreme Court to state corporate income taxes in *Underwood Typewriter Co. v. Chamberlain.*[5] In that case, the Court noted:

> "The profits of the corporation were largely earned by a series of transactions beginning with the manufacturing in Connecticut and ending with sales in other states. In this it was typical of a large part of the manufacturing business conducted in the state. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *(254 U.S. 120)*[6]

In *Butler Bros. v. McColgan, 315 U.S. 501 (1942)* the taxpayer sought to use separate accounting to establish losses in California whereas an apportionment formula assigned income to that state. The U.S. Supreme Court rejected the taxpayer's argument that separate accounting refuted a reasonable apportionment formula applied to the income of a unitary business.[7]

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[1] "Separate accounting" treats as a separate business that portion of the activities of the multistate business conducted in a particular state.

[2] Apportionment treats the activities of the multistate-multinational business both within and without the state as a unit. It divides this unitary income by means of a formula. The formula generally consists of equally weighted tangible property, payroll and sales factors. Thus, if Corporation A makes 50% of its sales in State B and has 10% of its properties and 30% of its payroll in State B, 30% of the unitary income of Corporation A would be subject to tax by State B.

[3] See, e.g., *State Railroad Tax Cases*, 92 U.S. 575 (1875) and *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1896), rehearing 166 U.S. 185 (1897).

[4] See *Cleveland, et al., R. R. Co. v. Backus*, 154 U.S. 439 (1894); in light of *Commonwealth Southern Railway Co.*, 193 Ky. 474, 273 S. W. 11 (1921); *Southern Railway Co. v. Commonwealth*, 204 Ky. 366, 264 S. W. 840 (1924); *Southern Railway Co. v. Kentucky*, 274 U.S. 76 (1927).

[5] 254 U.S. 113 (1920).

[6] See also, *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

The Unitary Method May Decrease Taxes

The unitary business method does not always increase a corporate business' tax liability. To the contrary, it is not unusual for a corporate taxpayer to pay less to particular states under the unitary method. This results from the ability to spread their profits among the different parts of their unitary business. For example, if one corporation operating in two states shows a loss while three others operating in other states show a gain, the losses can be offset against the gains to reduce total taxable income if the five corporations constitute a unitary business. For this reason many corporations voluntarily report their income on a unitary basis, even to states which do not use the unitary method as a general policy. California adopted the unitary business method largely because companies were demanding that the state allow them to use it.

It is questionable whether affiliated corporations ever deal at "arm's length" with each other.

What is a Unitary Business?

What constitutes a unitary business? The cases generally hold that the taxpayer is conducting a unitary business if the business is owned and controlled by the same interests and if the component parts of the business are essentially interrelated and interdependent.[8] No case holds that the corporate form in which that business is carried on is controlling in determining whether that business is unitary. The unitary concept is just as applicable to a unitary business conducted by a group of related corporations as to a unitary business conducted by one corporation. This is true if all the related corporations are domestic; it is also true even if some of them are "foreign."

Frank M. Keesling, sometimes called the father of the unitary method, remains a leading proponent of it and a renowned expert on it. He writes:

"Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where the business is conducted by one corporation, the income is computed as a unit and apportioned by means of an appropriate formula, usually the three-factor formula of property, payroll and sales. . .

"When the combined report is employed, exactly the same procedure is followed, and the same results obtained, in cases where the business is conducted by more than one corporation. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only." *(42 Journal of Taxation, 108, February 1975).*

The question frequently arises whether the income of corporations foreign to the U.S. should be included in the combined report. The answer is an emphatic 'yes'. The apportionment should be made by attributing to each state a portion of the income from the entire business regardless of whether the business is conducted between two or more states in the U.S. or between one or more of such states and one or more foreign countries. This can be accomplished only by combining the incomes of all the corporations engaged in the conduct of the business. It is immaterial whether such corporations are organized under the laws of one of the states of the U.S. or under the laws of a foreign country." *(42 Journal of Taxation 109)*

Take, for example, a multinational corporation which operates in Canada and Idaho through two subsidiary corporations. The Canadian subsidiary processes pulp for the manufacture of paper by the U.S. subsidiary. The pulp is transported from the Canadian subsidiary to the U.S. subsidiary by a pipeline crossing international boundaries. It is impossible to separate the profits of the two subsidiaries because the income of the two is intertwined in a series of transactions between them, beginning in Canada and ending in Idaho. Restrictions on the use of the unitary approach would permit this corporate businesses to use separate accounting to attribute (or fail to attribute) their income among the states according to their whim.

Where a taxpayer conducts interconnected or "unitary" business activities both within and without the taxing state, separate accounting is inappropriate, producing fictitious and even whimsical results.

Judiciary Committee's Views

After an extensive review of the problems of state business, the Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary of the House of Representatives made the following observation and recommendation:

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[7] See also, *Underwood Typewriter Co. v. Chamberlain, supra; Edison-California Stores v. McColgan*, 30 Cal. 2d 472, 183 A.2d 16 (1947); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal.2d 214, 238 P.2d 569 (1951); and *Western Auto Supply Co. v. Commissioner of Taxation*, 245 Minn. 346, 71 N.W. 2d 797 (1955).

[8] *Maxwell v. Kent-Coffey Mfg. Co.*, 204 N.C. 365, 168 S.E. 397, aff'd without opinion 291 U.S. 642 (1933); *Butler Bros. v. McColgan, supra; W. S. Dickey Clay Mfg. Co. v. Dickenson*, 286 S.W. 2d 538 (Tenn. 1956); *Western Auto Supply Co. v. Commissioner of Taxation, supra; Fleming v. Oklahoma Tax Commission*, 157 F.2d 888 (1946); *Edison-California Stores v. McColgan, supra;* Appeal of *F. W. Woolworth Co.*, Cal. State Board of Equalization, July 31, 1972, C.C.H. Cal. Tax Rep., para. 204-806; *Chase Brass & Copper Co., Inc. v. Franchise Tax Board*, 10 Cal.3d 496, 87 Cal. Rep. 239 (1970); *Honolulu Oil Corp. v. Franchise Tax Board*, 34 Cal. Rep. 552, 386 P.2d 440 (1963); *Zale-Salem, Inc. v. Tax Commission*, 237 Or. 261, 391 P.2d 601 (1964); *Butler Bros. v. McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1942).

"Often corporations which are controlled directly or indirectly by the same interests are so mutually dependent on each other for their success that the books of an individual corporation cannot accurately reflect the corporation's contribution to the profitability of the entire multicorporate enterprise. In short, separate accounting among affiliated corporations is often as inappropriate and as troublesome as is separate accounting among the branches of a single corporate entity. As a result, some states have formulated "unitary business" rules designed to treat the income of affiliated corporations in the same manner as though earned by a single business.

". . . In order to clarify this troublesome area and to provide standards which are both easy to apply and equitable in their effect, the Committee recommends that State tax administrators be allowed to require consolidation in any case where two or more corporations are affiliated by common ties of more than 50% of stock ownership and at least one of the affiliates has realty or an employee in the State."
(H. Rep. No. 952 (1965) at pages 1154-1155)

Despite the demonstrated need for the unitary business method, Article 9(4) of the proposed United States-United Kingdom Tax Treaty would force the states to use "separate accounting" to determine the state income tax liability of a domestic subsidiary of a United Kingdom parent.[*] The U.S. Treasury has conceded that, even though Article 9(4) would apply only to U.K. based multinationals, the exemption would soon be extended to multinationals based elsewhere as well. Indeed, it is not unreasonable to expect similar treatment for domestic parents in the near future.

The Unitary Method Versus Separate Accounting

Article 9(4) raises, among other issues, a basic question as to which of the two standards, the separate accounting or the unitary method, is more appropriate for the states. Let us compare them.

Both standards recognize that the common ownership and control of an affiliated group of corporations enables management to distribute the profits among those corporations at its whim when those corporations have dealings with each other. Any maldistribution of such profits can have significant income tax consequences. Therefore, tax administrators must have the authority to determine the true net income of any member of the affiliated group regardless of the accounting practices of corporate management.

The separate accounting standard assumes different income tax consequences if a unitary business is operated through one corporation rather than through several affiliated corporations. The unitary business standard holds that the results should be identical, i.e., that substance should prevail over form.

Thus, if a parent corporation manufactures a product, markets it through a sales subsidiary, and finances the sales through another subsidiary, the tax consequences are the same under the unitary business standard as if the manufacturing, sales and financing activities were carried on by separate divisions of the same corporation.

By contrast, under the separate accounting standard, the tax result would depend upon the corporate form. There would be a separate accounting of the manufacturing profit, the sales profit and the financing profit. If these same activities were carried on through divisions of the same corporation, they would be treated as unitary for tax purposes under the separate accounting standard. In other words, under this standard, form prevails over substance.

Often there is simply no evidence of what an arm's length price for [a] product or service would have been, either because there is no market, or because the product or service is unique.

Corporate management decides whether a business is conducted through one corporation or through many corporations. Thus, a tax reporting method based on the corporate form is vulnerable to the tax avoidance strategies of management. This is as true on the international level as it is on the interstate level. Since the "separate" corporations of a multistate-multinational business may be little more than accounting devices, it is apparent that corporate form should not control tax consequences.

Practical Reasons for Adopting the Unitary Method

So much for theory. There are practical reasons why the unitary business method must be available to the states. The basic reason is that the separate accounting method simply does not work in very many cases. Under this method tax administrators must examine all the transactions between related corporations to determine whether or not the price has been manipulated. When such manipulation can be proven to have occurred (a difficult task), the tax administrator must adjust the price to that which would have occurred between two unrelated corporations had they dealt "at arm's length."

Often there is simply no evidence of what an arm's length price for the product or service would have been, either because there is no market, or because the product or service is unique. For example, it is impossible to separate manufacturing profit from sales profit where a parent manufacturing corporation sells a unique product through its controlled subsidiary sales corporation.

If the arm's length standard does not work in this simple example, its application to the innumerable transactions between large multinational corporations and their affiliated corporations is even more difficult. Such corporations operate through literally hundreds of affiliates. Their intercorporate transactions involve hundreds of products and services, including copyrights, patents, royalties, component parts of finished products, overhead expenses, and so forth.

Problems in Applying the Arm's Length Standard

Consider the difficulty of applying the arm's length standard to determine the following:

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[*] This statement assumes that Article 9 of the Treaty does not prevent the states from making the arm's length adjustments permitted by Article 9(1). The Treaty is not clear on this point. If the states were not permitted to make such adjustments, they would be bound under the Treaty to accept at face value the "separate accounting" of the multinationals covered by its provision, except where the Internal Revenue Service had made adjustments under Article 9(1).

1. The "arm's length" price of a unique component part designed and manufactured by a subsidiary for assembly in its parent company's finished product.

2. The proration, among affiliated corporations, of centralized overhead or administrative charges such as those for executive management, legal services, accounting, or computer services, etc.

3. The value of copyrights, patents, royalties, trade names, trademarks, and the like utilized by various corporations of an affiliated group.

4. The proration of volume purchase discounts or volume sales at so-called "dumping" prices.

5. The proration of research and development expenditures and centralized advertising expenses.

Even the U.S. Treasury, with its superior resources, cannot make the arm's length method work in many such cases. A 1973 Internal Revenue Service report revealed that the method failed in 40% of the cases studied. At such times, the IRS often resorts to the unitary method. It uses formula apportionment in at least two instances: in apportioning research and development costs between foreign and domestic affiliates (Section 861 adjustments) and in apportioning income between a parent corporation and a DISC.

Indeed, in President Kennedy's 1962 tax reform package the Treasury advocated a form of the unitary method as a general federal policy. More recently, the Treasury has used the inadequacies of the arm's length method to justify President Carter's proposal to eliminate the deferral of "foreign" income for federal tax purposes.

In short, the U.S. Treasury itself has recognized in word and deed both the inadequacy of the arm's length method and Treasury's own need to use formula apportionment in at least some cases.

If the U.S. Treasury has difficulty with the arm's length method, the states have more. A recent Treasury study concedes that this method "would strain the administrative capability of many states." These states cannot afford, nor do they wish to have, the vast numbers of auditors and economists needed to comb through all the transactions of large multinational corporations.

A 1973 Internal Revenue Service report revealed that the [arm's length] method failed in 40 percent of the cases studied. At such times, the IRS often resorts to the unitary method.

The Unitary Method Is Simpler

The unitary business standard is simple by comparison with arms length pricing. Tax officials do not have to examine individual corporate transactions, nor do they have to second-guess pricing decisions. Using the unitary business method, these officials face only the task of determining what members of the group of affiliated corporations are engaged in a unitary business. Determining the income of this unitary business, and determining the factors by which income is apportioned among the states and nations in which it operates pose no difficult factual questions.

Some multinational businesses contend that the unitary business standard is complex and that the arm's length standard is not. As has been shown, quite the opposite is true. It is obviously much simpler to determine whether or not a United Kingdom parent and its United States subsidiary are conducting a unitary business than it is to analyze all the dealings between the United Kingdom parent and the United States subsidiary to determine whether these dealings have been "at arm's length." Indeed, it is questionable whether such affiliated corporations ever deal at "arm's length" with each other.

By Article 9(4) of the U.S.-U.K. Treaty, the multinational corporations seek to have their state income tax liability determined solely on the basis of corporate management accounting practices. The states vigorously oppose that ploy.

Multinational corporations also claim that the unitary business method results in the taxation of "foreign source" income. This claim merely begs the question. It assumes that the separate accounting practices of the multinationals accurately reflect how much of their income was gained in the U.S. But that is the very question to be resolved.[10]

Foreign Income Not Taxed

If the unitary business standard actually enabled the states to tax foreign income, the Courts would have struck it down long ago. Judicial precedent clearly requires that the states tax only that corporate income that is reasonably related to the taxpayer's activities within the taxing state. Furthermore, the Uniform Division of Income for Tax Purposes Act and comparable provisions in other state laws require the tax administrator to adjust any apportionment formula, if its application to a taxpayer does not reflect that income which is reasonably attributable to the state. The courts have uniformly held that the unitary method meets these standards of reasonableness.

The multinationals have been unable to convince the courts that the apportionment of unitary income is unreasonable even when it results in the assignment of income in excess of the amount of income which they would assign to the states by "separate accounting." In *Bass, Ratcliffe & Gretton v. State Tax Commission, supra*, the U.S. Supreme Court rejected the notion that separate accounting properly indicated a British corporation's taxable income for New York State. The court upheld a formulary apportionment result which differed substantially from that produced by "separate accounting."

States Need the Unitary Method

It is ironic that, at a time when the states are only beginning to comprehend and to capitalize upon these advantages, and when Treasury itself benefits from them, Treasury seeks to throw them away. The procedure by which it has sought to do so is even more surprising: deliberations from which the states were excluded and in which a treaty was negotiated with a foreign government.

The states deserve more respect. They need the unitary business method. They demand that Article 9(4) of the proposed Treaty be killed.

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[10] For example, in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 260 U.S. 271 (1924), the Supreme Court upheld apportionment of income of a highly profitable business to New York as a result of sales and sales activity in New York. At the same time, as indicated in that decision, the company attributed no net income to the United States for federal income tax purposes. Did New York tax "foreign source" income or did the United States Treasury Department fail to tax income which arose in truth from United States operations?

SPECIAL REPORT

THE U.K. TAX TREATY SHOULD BE RATIFIED WITHOUT RESERVATION

by John S. Nolan

John S. Nolan is a partner in the Washington law firm of Miller and Chevalier. He served as Deputy Assistant Secretary of the Treasury for Tax Policy from 1969 through 1972.

In this article, Mr. Nolan supports the reciprocal limitations on state taxing authority which are contained in Article 9(4) of the U.S.-U.K. Tax Treaty, which is now awaiting Senate action. He stresses that questions relating to that article cannot be answered in the abstract, as if some new and unreasonable limitation were being imposed on the states. He also points out that the proposed restrictions on the use of the unitary method by the states are needed to prevent states such as California from using that method to impose excessive tax burdens.

The fundamental problem with the unitary method, Nolan points out, is that it fails to take into account the wide differences in the economic circumstances faced by the various segments of multinational firms. Thus, while the unitary method might work within a homogeneous economic structure such as the U.S., it produces serious distortions when applied on a worldwide scale.

Mr. Nolan concludes with a defense of the separate accounting method, and the arms-length standard for transfer pricing, as means of allocating the income of multinational corporations. He finds that these methods have worked well at the federal level, and he urges their adoption at the state level.

Article 9(4) of the U.S.-U.K. Tax Treaty cannot be evaluated, as Mr. Dexter has done, on the basis of abstract tax theory applied to a hypothetical U.S. corporation operating in many states of the U.S. through various subsidiaries, or even a U.S. corporation with a Canadian subsidiary. Article 9(4) is in the proposed U.S.-U.K. treaty because California is grossly over-taxing U.S. subsidiaries of *United Kingdom corporations owned and controlled by U.K. residents*. This was clearly demonstrated by representatives of many British companies at the public hearings of the Senate Foreign Relations Committee.[1]

How Over-Taxing Occurs

This over-taxing occurs because when the California unitary concept is extended to worldwide operations of *foreign-owned* corporate groups, most of the operations of which are outside the United States, the result is often to seriously overstate the income allocated to California. Furthermore, this extension to foreign-controlled corporate groups imposes unreasonable (even impossible) administrative burdens on these foreign groups in determining worldwide income by California standards, in converting all of their worldwide income statements and balance sheets to dollars, in furnishing the records California seeks to obtain, and in otherwise meeting California's demands.

Unitary Approach Is New

Contrary to the impression created by Mr. Dexter, this extension by California of the unitary approach to worldwide operations of a foreign parent company is a relatively new and entirely unique development. It was not until the 1970's that California attempted to allocate to California part of the income of such a foreign parent and all of its subsidiaries throughout the world merely because the group had a U.S. subsidiary operating in California. The worldwide group income so allocated included the income of the parent and its third country subsidiaries even though they did no business in and had no connection with California, whether or not such companies in the group individually had any transactions with the U.S. subsidiary.[2]

This development is contrary to well-established international tax principles and customs. It has been met with astonishment and uniform objection and resentment by companies with worldwide operations which are based in countries which are our traditional trading partners. These countries include the United Kingdom, West Germany, Japan, France, the Netherlands, and Canada.

The issue presented by Article 9(4) is the treatment by California of companies such as these (in this particular case, companies owned and controlled by residents of the United Kingdom). The issue is not the treatment of *U.S.* multinationals by California or any other state of the U.S. Article 9(4) does not affect the right of our states to tax based on worldwide operations of U.S. corporations or even foreign corporations controlled by U.S. persons.[3]

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[1] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines:* Hearings before the Senate Committee on Foreign Relations, 95th Cong., 1st Sess., 184, 206, 212, 291, 295 (July 19-20, 1977) (hereinafter referred to as Hearings).

[2] Mr. Dexter makes much of the requirement that the business must be "unitary" for the method to be applied. Any study of the California practice will demonstrate that this is no longer a real condition for use of the method by that State. Indeed, Frank Keesling, who Mr. Dexter describes as the "father" of the unitary method, says that there probably is no such thing as non-unitary business and the worldwide income should be allocated by formula without regard to any such condition. Hearings, 189, 191.

The U.K. has responded in the appropriate way by seeking treaty protection. This is what treaties are for under the U.S. Constitution; they clearly may limit the way the Federal Government or the states tax residents of the other country. There is solid precedent for Article 9(4) in prior U.S. tax treaties, which also operate to restrict the taxing power of either treaty country, or its political subdivisions, with respect to residents or companies of the other country.[4] Incidentally, it is important to recognize that Article 9(4) would impose *reciprocal* restrictions, providing important protection to U.S.-owned corporate groups from unfair taxation by the *other* country or *its* political subdivisions.

Article 9(4) is in the proposed U.S.-U.K. treaty because California is grossly over-taxing U.S. subsidiaries of U.K. corporations owned and controlled by U.K. residents.

Only California, Oregon, and Alaska have extended the unitary concept to apply to foreign-owned and controlled corporate groups.[5] None of our other states will be affected by this treaty or any subsequent treaties that might contain a provision similar to Article 9(4).

The Objections to the Unitary System

The fundamental objection to extending the unitary system to foreign-owned worldwide groups arises because formula apportionment of worldwide income based on relative property, plant, and payroll in money terms tends to over-allocate income to the United States and its political subdivisions by reason of economic, tax, and other factors in today's world.

The unitary system may work reasonably well in allocating income within a homogeneous economic structure, such as the United States, but it fails to do so when it applies to diverse foreign income which arises principally outside of any such single structure. In the case of *foreign-owned* corporate groups, the United States operations normally represent only a minor part of their total worldwide operations. This is especially true of U.K. corporations; U.K. businesses traditionally reach into every corner of the world by reason of U.K. dependence on world trade.

Comparing Incomparables Produces Misallocation

The unitary method applied to worldwide operations, when such operations are not largely confined to the U.S., allocates income based on payroll amounts, property costs, and sales which cannot fairly be compared. A higher portion of total income is allocated to the location where these factors are the highest in relation to income. The allocation would be appropriate in these circumstances only if income bore the same relationship to costs throughout the world, irrespective of the amount of such costs. This is clearly not the fact. As compared to the U.S., profit margins vary widely throughout the world and bear no such uniform relationship to costs.[6]

Consider the payroll allocation factor. United States (and especially California) wages per hour are generally much higher than elsewhere in the world, and even after allowance for captial intensity and productivity, the payroll factor tends to over-allocate income to California. California has refused to reduce the extent of this distortion by applying the payroll factor in terms of hours rather than dollar wages.

Property costs are also substantially higher in the United States (and, again, especially in California) than elsewhere in the world, with the same distortive effect because of the application of the property factor. California also has stringent pollution control requirements, causing a relatively higher property investment per unit of production in that state without an equivalent increase in profits; in fact, such non-productive property costs may reduce actual California profits. This causes the property factor to over-allocate income to California.

Even the sales factor causes major distortions when income arising outside a homogeneous economic system is allocated. For example, one U.K. corporate group, with extensive worldwide operations, has a U.S. subsidiary engaged in sale of tobacco products in the United States. The heavy U.S. federal and state tobacco excise taxes are reflected in U.S. sales, without any proportionate increase in profit margins, causing an over-allocation of worldwide income to California pursuant to the sales factor.

California even applies its unitary method to allocate income to California when it is demonstrable beyond reasonable question that actual operations in California have resulted in a loss.[7]

U.S. (and especially California) wages per hour are generally much higher than elsewhere in the world . . . The payroll factor [therefore] tends to over-allocate income to California.

Demonstrable differences in the relationship of profits to sales have also been ignored, thereby tending to over-allocate income to California. For example, one U.K.-controlled group has diverse business activities all over the world. Its U.S. activities are limited almost entirely to its food and wine operations, which represent 44.4% of total group sales but only 30.3% of operating profits. The group's household and toiletry operations, which extend to the United States only to a very insignificant degree, represent only 35.1% of group sales but contribute 49.1% to the group's operating profit. Obviously, an allocation of group profit to California based on sales will allocate far too large a share of group income to California.[8]

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[3] Hearings, 27, 34-35, 188, 192-193.

[4] Hearings, 21-23, 194-196. The U.S. treaty with France of November 25, 1959, described at page 196 in the Hearings, is particularly relevant; it appears already to restrict California from applying the unitary method to worldwide income of French corporations. See also *Scandenavian Airlines System v. Los Angeles*, 52 Cal. 2d 11, 363 P. 2d 25 (1961).

[5] Hearings, 27, 32-33.

[6] See, for example, Hearings, 208-211, 291-295, 296-302, demonstrating beyond question that higher profit margins abroad of foreign banks result in allocation of foreign source income to California.

[7] Hearings, 296-302.

Adjustments Needed

Worldwide profits cannot be allocated without adjustment for other demonstrable differences. For example, profits in developing countries may be much higher in relation to costs to reflect greatly increased risks of expropriation, currency exchange limitations, or other such factors. The result may be to allocate part of this risk profit, which is really a contingency reserve, to California. Worldwide income may be allocated by California even when such income includes substantial profits in foreign countries which are blocked and which for this reason would not be subject to federal tax in the case of a U.S. taxpayer until they become unblocked.

It is no answer, as Mr. Dexter suggests, that these or other considerations might in particular cases work in reverse to under-allocate income to California. The real point is that the extension of the unitary concept to allocate income — which includes income arising outside a homogeneous economic system such as the United States — almost certainly introduces major distortions. These distortions would not arise under the alternative application of the arm's length standard as it is rigidly enforced by the Internal Revenue Service.

Allocating Before-Tax Income

The unitary system applied to worldwide income also produces gross distortions because it allocates *before-tax* income. Taxes imposed on income by governments throughout the world do not bear any uniform relationship to income (and more importantly, to the location of property, payroll, and sales). In many important areas of worldwide business activity, taxes are higher than in the U.S. The result is almost certain to produce a distortion in the amount fairly allocable to California. In a sense, the California tax becomes a tax on a tax, or at least an income tax on income that has already been fully taxed and is required to pay the tax already imposed.

The unitary method allows no credit for taxes paid another state or a foreign country, the presumpution being there is no double taxation of income allocated to the state. In actual effect, the result is the plainest kind of extraterritorial taxation — an unfairness that should not be permitted to exist for any taxpayer.

Unreasonable Administrative Burdens

There is a second major reason why in the case of a foreign-controlled corporation doing business in California, or a U.S. subsidiary of such a foreign-controlled group, the unitary method should *at most* take into account only foreign income of the company doing business in California and its subsidiaries, and not income of other affiliated corporations not doing business in California. It is an unreasonable burden, if not an impossible burden, for a foreign group not controlled by U.S. persons to provide the financial information to the state that is required to make such a unitary computation.

A U.K.-owned and U.K.-based worldwide group does not keep its books, or determine income, payroll, plant costs, and sales, in dollars, or by U.S. accounting standards. The required conversion of financial figures to dollars at scores of different exchange rates, with sharp fluctuations, devaluations, and other changes, is an operational nightmare for a foreign-based group with extensive international operations.

After conversion to dollars it is next necessary to make adjustments for differences between financial and taxable income. California does not even follow U.S. federal income tax accounting and other concepts in some respects. The cost of compliance with the California requirements in the case of a U.K. worldwide group is estimated by some to be far in excess of the California tax itself.

The unitary system applied to worldwide income also produces gross distortions because it allocates before-tax income.

California has also sought in some cases to force disclosure of secret financial information. California has sought information as to the operations of the foreign parent and third country subsidiaries that go beyond all reasonable bounds.[9]

Ways and Means Task Force Evaluations

Objections to extending the unitary concept to allocate worldwide income have been thoroughly evaluated by others. A House Ways and Means Task Force concluded that the states should be precluded —

> * * * from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to federal income tax.[10]

After exhaustive hearings and study, the Willis Subcommitee had earlier reached the same conclusion, and Senators Ribicoff and Mathias have sought on several occasions to cure the obvious inequities of the effect of the state unitary computations in allocating foreign source income as a base of taxation.[11]

Separate Accounting

Mr. Dexter alleges that separate accounting is unworkable and that a 1973 Internal Revenue Service study concludes that section 482 is not effective in many cases. This simply is not so. At most, Article 9(4) will require only that transactions between the U.S. subsidiary and its U.K. parent or U.K. or third country subsidiaries be monitored under section 482-type standards. The Internal Revenue Service already does this monitoring and furnishes all the results to the states.

This consideration was an important reason why Governor Rockefeller of West Virginia, after "extensive review and further evaluation," recently changed his position to support the treaty. He also observed that West Virginia would gain rather than lose revenue by reason of the treaty, and that it would bring needed equity in the tax treatment of U.S. corporations conducting business abroad (by reason of the reciprocal restrictions on the other treaty country and its political subdivisions).[12]

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[8] Hearings, 188, 198-199, 206-211.

[9] Hearings, 188, 199-200, 212-219, 285-302.

[10] Recommendations of the Task Force on Foreign Source Income, House Ways and Means Committee, 95th Cong., 1st Sess. (March 8, 1977).

[11] See Hearings, 188, 200-202.

Mr. Dexter's references to the 1973 IRS study of section 482 are mysterious; no citation appears in Mr. Dexter's article and it is not discussed in California's Critique of Arm's Length Concept in the Hearings on this treaty, pp. 119-139 (which is not convincing). The hearings do contain at page 308 a memorandum from Commissioner Kurtz affirming that the arm's length standard of section 482 prevents mispricing; Commissioner Kurtz states that the Service does not use, or contemplate using, a unitary system "as the results would not reflect a reasonable arm's length standard or acceptable accounting standards and practices" and that the Service feels that it is adequately combating abuse through the use of the arm's length standard. At the very least, this would seem to discredit the 1973 study.

Arm's Length Transfer Pricing

The arm's length standard has long provided a common basis for understanding between the different foreign governments with which the United States has tax treaties. It appears as the basic principle for monitoring intercompany relationships for purposes of income taxation by each of the contracting nations in each of its thirty-seven bilateral income tax treaties now presently in force.

The extensive IRS regulations under section 482 designed to insure fair allocation of income of related members of a corporate group have worked successfully, and the Internal Revenue Service vigorously applies the arm's length standard. My own experience of thirty years of federal tax practice, including three with the Treasury Department, qualifies me to state that section 482 is indeed workable and effective in monitoring international intercompany transactions to insure fair results.

Substantially every U.S. company with substantial foreign operations is audited by the Revenue Service. As previously stated, the results of this monitoring are fully available to the states under the federal system whereby states of the United States may compare income reported to them with income reported to the federal government and obtain the complete details of the Internal Revenue Service adjustments.

The cost of compliance with the California requirements in the case of a U.K. worldwide group is estimated by some to be far in excess of the California tax itself.

Furthermore, the unitary business method is contrary to well-established international tax principles. An all-embracing principle of the arm's length standard, instead of the unitary business method, was embodied in the model income tax convention of the Organization for Economic Cooperation and Development (OECD), which consists of the principal trading nations of the world. The OECD model treaty specifically applies this rule to subsidiary levels of government. The 1974 Guidelines for Tax Treaties Between Developed and Developing Countries, prepared under the auspices of the United Nations, adopts the same principle.

The unitary business method is contrary to well-established international tax principles.

The weight of world authority is contrary to Mr. Dexter's assertions.

Treaty Should Not Be Jeopardized

Mr. Dexter ignores the fact that if the Senate reserves on Article 9(4), the Treaty must be renegotiated, at tremendous potential loss to the U.S., to the states themselves, and to millions of U.S. investors holding shares in U.S. companies doing business in the United Kingdom. This is well summarized in Assistant Secretary Lubick's recent letter to Governor Shapp:

> One of the major benefits of the convention is its provision for refunds from the United Kingdom Treasury to U.S. direct and portfolio investors. * * * These provisons are retroactive to 1973 for portfolio investors and to 1975 for direct investors. If the convention is ratified this year, cumulative refunds of approximately $375 million will be paid to U.S. investors. Annual refunds subsequently will total about $85 million.
>
> These refunds eliminate the discrimination against U.S. investors which is inherent in imputation-type integration systems when refunds are not provided. We view the dividend provisions in the convention as a significant breakthrough in our efforts to mesh the United States tax system with such integrated systems. We hope that the United Kingdom convention will constitute a precedent in our negotiations with Germany, Canada, France, and other countries. . .

Assistant Secretary Lubick then makes the following critical point:

> The U.K. Parliament has already approved the convention. If the Senate reserves on Article 9(4) the entire convention must be sent back to the British Parliament for reconsideration. Since the unitary tax provison was a material element in the overall package which the Parliament approved, a reservation is likely to lead to a very careful British re-examination of the new balance of benefits in the convention.
>
> If it determines to reapprove the convention, Parliament might make reservations of its own which could be costly to U.S. taxpayers, the Treasury, and the states, and which would, inevitably, further delay implementation of the convention. For example, if Parliament were to reserve on the effective date provisions and insist on prospective effective dates, this action would cost the U.S. between $300 and $400 million.[13]

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[12] Letter from Honorable John D. Rockefeller, IV, Governor, State of West Virginia, to Senator John J. Sparkman, Chairman, Senate Foreign Relations Committee, dated March 3, 1978.

[13] Letter from Honorable Donald C. Lubick, Assistant Secretary (Tax Policy), United States Treasury Department, to Honorable Milton Shapp, Governor, State of Pennsylvania, dated February 25, 1978.

Several matters require emphasis. The states themselves will gain much from the Treaty; the U.K. refunds will be treated as dividends, and most states include foreign dividend income in their tax base. The benefit involved is a refund of *U.K.* taxes to U.S. parent companies and to U.S. portfolio investors in U.K. companies, not U.S. taxes. This will reduce the foreign tax credit and thereby substantially *increase* tax liabilities of U.S. companies to the U.S. Some of the benefit will be realized by the U.S. companies and their shareholders. The Treaty is a critical precedent for obtaining similar concessions by other major foreign governments where we have large direct and portfolio investments.[14]

Treaty Should Not Be Evaluated In Abstract Terms

This Treaty is far too important to the United States to be evaluated in abstract terms, as if, some new and unreasonable limitation were being imposed on the states. The weight of world tax authority, and long-established international tax principles and customs, support Article 9(4). The unitary method as applied to worldwide income of foreign-owned corporate groups is unfair, impossibly burdensome, and unsound in principle and in practice. Foreign governments uniformly object to it and will continue to insist on treaty protection.

Governor Brown of California came to understand all too well that foreign capital will no longer be invested in California, and that existing foreign capital investments there are being withdrawn, because of this extension of the unitary method. He, together with Senators Cranston and Hayakawa, support the Treaty.[15] The California legislature is presently considering bills to limit the use of the unitary method to exclude consideration of non-U.S. income in the allocation.

The unitary method as applied to worldwide income of foreign-owned corporate groups is unfair, impossibly burdensome, and unsound in principle and in practice.

The Treaty would provide *reciprocal* protection to U.S. companies as well and would insure that each government, and its political subdivisions, would do no more than adhere to established international tax principles and customs in dealing with international transactions.

The Treaty should be ratified by the U.S. Senate without reservation as to Article 9(4).

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[14] See Hearings, 188, 189-190.

[15] Telegram from Honorable Edmund G. Brown, Jr., Governor, State of California, and Senator Alan Cranston, to Senator John J. Sparkman, Chairman, Senate Foreign Relations Committee, dated September 27, 1977. Hearings, 77-82.

BRAZILIAN TAX CREDIT

The introduction to the letter to the editor on page 351 of the April 3, 1978 issue of Tax Notes *should contain the following information: the authors, Messrs. Guttentag and Nauheim, of Surrey, Karasik and Morse, Suite 1200, 1156 15th Street, N.W., Washington, D.C. 20005, are registered with the Department of Justice as foreign agents of Banco de Brazil, 550 5th Ave., New York, New York 10036, an instrumentality of the Brazilian Government. A copy of this Registration Statement is available for inspection at the Department of Justice and copies of this letter have been filed with the Department of Justice. Registration under the Foreign Agents Registration Act does not indicate approval by the U.S. government of the contents of this material.*

NEWS BRIEFS

REPORT TO BUDGET COMMITTEE ON FY 79 BUDGET. Included in this report are recommendations on the fiscal year 1979 budget, a summary of budget authority and outlays and examinations of revenues and customs receipts, the budget deficit, the public debt limit and tax expenditures. Report of the Ways and Means Committee to the House Budget Committee, March 15, 1978. *Doc 78-2008*

ESTIMATES OF FEDERAL TAX EXPENDITURES. This report contains tax expenditure data, grouped by functional category, intended to show the cost to the federal government, in terms of revenue foregone, of tax provisions that have been enacted as incentives for the private sector of the economy. Prepared for the Ways and Means Committee and Finance Committee by the Joint Tax Committee, March 14, 1978. *Doc 78-2009*

ROTH DEFENDS HIS PROPOSED TAX CUT. Citing a recent Harris poll survey in which "a whopping 70 percent of the respondents felt 'taxes in this country are unreasonable,'" Sen. Bill Roth, R-Del., claims that "Americans badly need a *real* tax cut." Roth defends the "straightforward, across-the-board tax cut called for in the Roth-Kemp bill" as a tax cut that "will go a long way to restoring economic growth, increasing individual incomes, creating jobs and restoring incentives to our economy." *Doc 78-2005*

. . . AND KEMP JOINS IN THE DEFENSE. Rep. Jack Kemp, R-N.Y., claims that the problem in America today "is that incentive is being taxed away." Accordingly, Kemp defends the Roth-Kemp bill as a proposal that will substantially cut individual and business tax rates, thereby creating "an immediate growth of economic output, employment and investment." *Doc 78-200*

SPECIAL REPORT

A CLOSING RESPONSE TO MR. NOLAN'S VIEWS

by William D. Dexter

Just as John S. Nolan, the author of the preceding special report, had an opportunity to consider and respond to William D. Dexter's opening article in this debate, so too Tax Notes gave Mr. Dexter an opportunity to respond to Mr. Nolan's views. The following article is the result.

In answering Mr. Nolan's arguments for inclusion of Article 9(4) in the U.S.-U.K. tax treaty, it is important to note what he does *not* deny, what he ignores, and what he assumes in the course of his argument.

First he does not deny that the "arms-length" standard is based on the "form" rather than the "substance" of international business operations. This means that with the arms-length method, international businesses can avoid income taxes by manipulating the corporate forms through which they conduct their business — i.e. through corporate "shell games."[1] They can operate abroad through branches or alternatively, through affiliated corporations, depending on which arrangement produces the lowest tax.

Second, Mr. Nolan does not deny that the states lack the capability to prevent this avoidance unless they can employ the unitary concept and thereby treat international businesses the same for state income tax purposes irrespective of the corporate "form". To the extent "arms-length" adjustments can prevent tax avoidance by use of the corporate "form", Mr. Nolan does not deny the conclusion of the 1976 Treasury Report that the "arm's-length" standard would strain the administrative capabilities of many states."

Third, he does not deny that there are administrative and judicial safeguards which prevent any state from taxing "foreign income," i.e., any income that is not reasonably related to sources and activities within the state.

Fourth, he does not deny that the unitary concept was properly upheld by the United States Supreme Court in 1924[2] and many times since as a fair and reasonable method to cope with the arbitrary assignment of international income by "separate accounting."[3]

Fifth, Mr. Nolan does not seem to deny the conceptual validity of the unitary method. At the very most, he alleges isolated abuses and a need for refinement of the apportionment formula in particular cases.[4]

Based on the foregoing, it appears that Mr. Nolan has conceded the general superiority of the unitary concept over the "separate accounting" or "arm's-length" standard in assigning income of a unitary business to the states for state income tax purposes. However, he purports to carve out a "limited" Article 9(4) exception for purely international businesses conducted through affiliates of a foreign parent.

The arm's-length standard would strain the administrative capabilities of many states.

A More Ambitious Purpose

But Mr. Nolan and the multinational corporations are actually more ambitious, and Mr. Nolan himself has admitted a larger strategy. In a letter dated November 27, 1977 to Dr. Charls Walker, the noted corporate tax lobbyist, Mr. Nolan wrote: *Thus, the problem [i.e., state taxation of multistate corporations] probably will be solved, if at all, only by starting with modest limitations on*

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[1] As noted by Jerome R. Hellerstein in "The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies," 27 *The Tax Executive*, July 1975, No. 4, at pp. 317-318; ". . .the organization of a business enterprise, for whatever purposes, by means of subsidiaries, as distinguished from branches, ought not to affect its state income tax liabilities."

[2] *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 260 U.S. 271 (1924).

[3] As noted by Mr. Hellerstein, *Supra*, note 1 at p. 315:

"Over the years, separate accounting has come in for increased criticism, in theory as well as because of its impracticability and excessive costs." (Citing Albert H. Cohen, "Apportionment and Allocation Formulas and Factors Used by States in Levying Taxes Based on or Measured by Manufacturing, Distributive and Extractive Corporations," Research Report prepared for Controllership Foundation (1954) and "State Taxation of Interstate Commerce," Report of the Special Subcommittee of the Judiciary Committee ("Willis Subcommittee"), 88th Congress, 2nd Session, H.Rep. No. 1480, Vol. 1, pp. 163-167 (1964).

[4] In recognition of this problem, Section 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA, Uniform Laws Annotated, Vol. 9a, p. 448) specifically provides for adjustment of the apportionment formula contained in the act, if the formula does not "fairly represent the extent of the taxpayer's activity" in the taxing state. Under UDITPA, which has been adopted by California, the taxpayer is entitled to the relief either on petition or by unilateral administrative action.

the California practice through tax treaties. It may then become possible to achieve a broader legislative solution.

In other words, Article 9(4) is much more than Mr. Nolan represents it to be in his article. Indeed, both state and federal legislators will be hard put to deny U.S. based corporations what Article 9(4) and its inevitable progeny would give to their overseas competitors.[5] Furthermore, the restriction of the unitary concept to the domestic corporations of an affiliated unitary group would undermine the integrity of the unitary approach.

Article 9(4) would hang over the heads of all the states the precedent of the federal government using the treaty process to dictate policies to them.

For these reasons, all of the states — not just the three that Mr. Nolan mentions — would be affected by Article 9(4). Moreover, all the states would lose the options both of turning to the unitary method in the future, or, more importantly, of using this method as a back-up in the many cases in which the arm's-length method simply will not work (40% of the cases, according to the Treasury's own study).[6]

Most important, Article 9(4) would hang over the heads of all the states the precedent of the federal government using the treaty process to dictate policies to them. This precedent could only work to the disadvantage of the states in the future. Thus, the purported narrow scope and limited purpose of Article 9(4) advanced by Mr. Nolan does not square with reality. In reality, Article 9(4) is a Trojan horse concealing a broad attack on the unitary concept to which the states have turned, according to a noted scholar, "out of sheer necessity."[7]

Should State Tax Rules Be Set by Treaty?

Mr. Nolan ignores the main issue posed by Article 9(4). This issue is whether the treaty process is an acceptable method for the federal government to use to dictate to the states tax policies which directly intrude on their Constitutional powers. This is a crucial issue, because the states are completely excluded from treaty negotiations. Their rights and powers may be bargained away by the federal bureaucracy, as they were in the U.K. Treaty, without their participation or even their knowledge. This is a flagrant violation of simple fairness, let alone the traditions and values of the federal system.

Mr. Nolan also ignores the fact that "arms-length adjustments" are simply a refinement of an attempt to separately account for the profits of the artificial parts of an integrated multinational business. By so doing, he begs the question of whether any "separate accounting" in such a case is not in itself inherently arbitrary. The Supreme Court of the United States in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), held that "separate accounting" had no inherent accuracy or special validity for the assignment of the income of a unitary business.

Mr. Nolan also ignores the substantial weight of both scholarly and judicial authority questioning the adequacy of the "arm's-length" standard. One of many recent examples is an extensive comparison of the unitary and "arm's-length" methods in the *Harvard Law Review* which concluded as follows:

> *While the unitary theory itself is not free from difficulty, it has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to current [i.e., federal arm's-length] practice.*[8]

In addition, Mr. Nolan ignores the protracted litigation that the complicated arms-length method invites. An example is a recent case in which both the Treasury Department and DuPont have expended ten years and over $1 million apiece in costs to litigate "arm's-length" adjustments. The prospect of such protracted litigation forces tax officials into making generous settlement offers. Multinational corporations know this, and find it a congenial situation, but the states do not.

Furthermore, Mr. Nolan ignores the fact that the Treasury Department has justified the President's current proposal to terminate deferral of the "foreign" income of U.S. corporations largely on the basis of the weaknesses of the "arms-length" method through which the existing deferral rules have been enforced. This is inconsistent with the Treasury's endorsement of the arms-length method in the context of the U.K. Treaty.

Mr. Nolan also ignores the fact that the information required of taxpayers under the "arm's-length" method is far greater than that required under the unitary method. In further justification of the President's proposal to eliminate deferral, the Treasury Department itself dismisses the alleged compliance problems of the unitary method, such as currency conversion and the like, as "surmountable."[10]

Mr. Nolan ignores how many multinational taxpayers have openly acknowledged their unitary nature and have endorsed the unitary method of taxation. The Exxon Corporation has recently argued in favor of the unitary concept in Alaska. "We believe Alaska's present [unitary] income tax law as it is applied to the oil and gas industry in Alaska," Exxon told the state's voters in a published advertisement, "is equitable and provides uniformity." Exxon went on to warn that "a departure from this uniformity could result in overlapping taxation by the states." Furthermore, Exxon has stated in a letter to the late Senator Phillip Hart that "The petroleum business is unitary in nature."

Multinational corporations have regularly taken state tax officials to court to compel them to accept tax reports computed on a unitary basis. California was virtually forced to adopt the unitary method as general policy, because so many corporations insisted on filing their tax returns on that basis.

Many Legal Problems Ignored

Finally, Mr. Nolan ignores the many legal problems posed by Article 9(4) of the U.K. Treaty. For example, the states could be "whipsawed" by multinational taxpayers.

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[5] The next step is to label all income from overseas affiliates as "foreign source income" and urge Congress to exempt such income for state income tax purposes or alternatively, to assign such income to the "commercial domicile" of the U.S. parent, where it is generally exempt.

[6] This figure, referred to in my article, is questioned by Mr. Nolan. It was taken from United States Treasury, "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code," January 8, 1973.

[7] *Supra*, Note 1, p. 314.

[8] "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code," 89 *Harvard Law Review* 1202, 1236, (1976).

[9] *The President's 1978 Tax Program*, pp. 282-283.

[10] *Id.*, p. 283

while Article 9(4) would prohibit the states from applying the unitary business method, the multinational taxpayers could still use this method, when it would work to their advantage. In addition, U.S.-based multinationals may be able to claim the benefits of Article 9(4) under the equal protection standards in the federal and state constitutions.

Furthermore, the wording of Article 9(1) when construed in conjunction with Article 9(2) and (3) may preclude the states from using even the "arm's-length" adjustments (either alone or by piggybacking on IRS adjustments) which are purportedly available to the Treasury Department under Article 9(1). The reason is that Articles 9(2) and (3) apply only to the "contracting states," i.e., to the U.S. government and Great Britain, and do not refer to political subdivisions, i.e., the fifty states.

Most important, Article 9(1) restricts the Treasury Department's own authority to make the adjustments permitted by Section 482 of the Internal Revenue Code. Section 482 reads in material part:

> *In any case of two or more organizations, trades or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution apportionment, or allocation is necessary to reflect the income of any of such organizations, trades or businesses.*

On the other hand, Article 9(1) of the U.K. treaty reads:

> *Where the enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.*

The Treasury Department, under Section 482, uses not only the "arm's-length" test, but also the unitary concept, or some elements of the unitary concept, to adjust the income of related enterprises.[11] However, the language of Article 9(1) apparently would prevent the Treasury Department from using the unitary entity theory at all and would seriously impair its ability to use even the arm's-length standard. Article 9(1) would impose highly restrictive, unrealistic and virtually unenforceable conditions which the Treasury Department must meet before it could make any arm's-length adjustments.

Article 9 would also permit multinational taxpayers covered by the treaty to control the assignment of their profits except when the Treasury Department can prove that the dealings *would have been different* if independent enterprises were involved. This is a "but for" test, as opposed to the current "arms-length" test.

Moreover, while Article 9(1) adjustments depend upon a finding that conditions between the two related enterprises are different than they would have been between independent enterprises, there are no standards for determining when this is so. As a consequence, even if the states can ride piggyback on federal Article 9(1) adjustments, as Mr. Nolan contends, they are likely to find themselves on a long, slow ride to nowhere, with the multinationals calling the shots by means of their bookkeeping and accounting decisions.[12]

In any event, the language of Article 9(1) is simply not the same as the language of Section 482. Therefore, the courts will probably interpret them differently. For this reason, Mr. Nolan's argument pertaining to the Treasury Department's successful and vigorous enforcement of Section 482 is left dangling in mid air.

The Underlying Question: How to Allocate Income

Mr. Nolan erroneously assumes that the courts permit the states to apply the unitary method to non-unitary businesses in a manner which seriously overstates the income attributable to the taxing state. To the contrary, the Supreme Court of the United States has consistently interpreted the due process and interstate commerce clauses of the federal Constitution to limit a state's taxing power to income derived from sources within that state.[13]

A state cannot reach beyond its borders to tax anything. This includes California. The underlying question, which Mr. Nolan begs, is "What is the best method for distinguishing the foreign income, which states cannot tax, from income which legitimately is within their power to tax?"

From the state's viewpoint, supported by numerous Supreme Court decisions, the most reasonable or equitable approach is the unitary method. The only reason the multinationals are taking their "separate accounting" approach to the U.S. Senate floor as part of the treaty-making process, bypassing both the Senate Finance Committee and the entire House of Representatives, is that they have not been able to convince the Courts, the Congress, and the state legislatures of the correctness of their views. By tying their long-sought restriction on the unitary method to a large treaty package, where it is like a rider to an important appropriations bill, they are hopeful that opponents will be pressured to accept it.

The information required of taxpayers under the "arm's-length" method is far greater than that required under the unitary method.

While this may be good political strategy, (depending on one's definition of "good"), it is not good policy making. The proposed restriction on state taxing powers should be considered by the whole Congress on its merits, free from the treaty ploy, in light of its precedential and long range effect. The Treasury Department and multinational corporations should not be allowed to thwart the normal political process and run roughshod over the states.

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[11] *Supra*, Note 8, p. 1238. The article notes that:

> *The use of the arm's-length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the surprisingly frequent reliance of revenue agents and courts on ad hoc fourth method approaches, based not on the theory of the regulation but on the unitary entity theory.*

[12] One must conclude that since the language of Article 9(1), without any explanation, departs markedly from the language of section 482, there was a significant reason for the language change. Neither Mr. Nolan nor the Treasury Department has offered any explanation for this. One can only guess at what was intended by the language employed.

[13] *Northwestern Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *General Motors Corp. v. Washington*, 377 U.S. 436 (1964).

Does the Unitary Method Misallocate Income?

As a second assumption, Mr. Nolan recites the by-now familiar argument that the unitary method "misallocates" income to the U.S. Questions of allocation (or misallocation) arise under any method of allocating multinational corporation income (i.e. of splitting income up among taxing jurisdictions).

Multinational corporations have regularly taken state tax officials to court to compel them to accept tax returns computed on the unitary basis.

To eliminate the unitary method is not to eliminate the allocation problem; it is merely to transfer the problem to a more complicated arena. Fewer questions arise under the unitary method than under the arm's-length method. Mr. Nolan says nothing which disproves this point. In practice, multinational corporations have contested as arbitrary the arm's-length apportionments of the Internal Revenue Service at least as vigorously as they have contested unitary apportionments by the states. The *DuPont* case, mentioned above, is only one example of the magnitude of arm's-length method disputes.

To argue that the unitary method "misallocates" income is merely to beg the question, "compared to what?" The very allegation of misallocation assumes that an attempt to allocate the income of an integrated multinational corporation, such as British Petroleum, among its numerous subsidiaries throughout the globe, can be anything but arbitrary. Apportionment of unitary income by a well-balanced formula is less arbitrary than the corporate "shell game" separate accounting alternative that Mr. Nolan proposes in his defense of Article 9(4).[illegible]

Furthermore, in arguing misallocation by the unitary method, Mr. Nolan gives short shrift to a very important point — that the unitary method often works to the taxpayer's advantage. This point is important for two reasons. First, it shows that states which use the unitary method do so for uniform and effective tax administration, and not to soak their corporate taxpayers. And more important, this point demonstrates that Mr. Nolan's sweeping generalities about the apportionment factors merit close examination.

Mr. Nolan argues, for example, that the payroll and property factors in the three-factor formula misallocates income into the U.S. because wage rates and property values are higher here than they are abroad. Yet, according to Commerce Department figures, a full 2[illegible]% of U.S. foreign investment is in Canada, where wage rates are *higher* than they are in the U.S. A substantial amount of the remaining U.S. foreign investment is in countries in which wage rates are comparable to or higher than those in the U.S. It is well known, moreover, that property values in many other parts of the world are considerably higher than they are here.

The Use of Corporate Tax Havens

In assuming misallocation of income by the unitary method, Mr. Nolan has neglected to mention that many multinational taxpayers try to allocate as much of their income as possible to such international tax havens as Singapore and Hong Kong. The unitary method thwarts such efforts, efficiently and with much less bureaucracy than is required under the arm's-length method. This effectiveness is a major reason multinational taxpayers are so opposed to the unitary method.

Virtually all of Mr. Nolan's misallocation arguments are simply a rehash of the old refrain that an apportionment formula arrives at an unreasonable and invalid result if it assigns more income to a taxing jurisdiction than the taxpayer would allocate by separate accounting. The courts have repeatedly rejected this contention.[illegible]

Mr. Nolan also seems to assume that the arm's-length standard prevents mispricing. He bases this assumption on his own experience and on a memo from IRS Commissioner Kurtz "affirming that the arm's-length standard of section 482 prevents mispricing."

Even if the states can ride piggyback on federal . . . adjustments, they are likely to find themselves on a long, slow ride to nowhere . . .

What Mr. Kurtz means by "mispricing" and what Mr. Nolan considers to be workable and effective is left unexplained. When multinational corporations promote a tax enforcement system as vigorously as they espouse the arm's-length method, tax administrators and policy makers are advised to examine that method carefully.

Difficulties in Applying the Arms Length Standard

Furthermore, Mr. Nolan's sanguine view of the arm's-length method is refuted by the experience of government attorneys who have tried to litigate arm's-length pricing cases, as well as by corporate officials, legal scholars, and even the Treasury itself in its current presentations to Congress regarding tax deferral for controlled foreign corporations. In those presentations, Treasury notes that:

> *Terminating deferral will reduce the incentive inherent in present law for U.S. taxpayers to avoid U.S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.*[illegible]

Exxon, in response to a letter from the late Senator Hart, refused a detailed breakdown — i.e. a separate

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[illegible] *Tax Notes*, in its September 1 and October 20, 1975 issues reported that for several years in the 1970's Getty Oil did not report any taxable income to Delaware, where it had substantial properties, payrolls, and investments. Getty apparently achieved this remarkable feat through its transfer pricing arrangements with its subsidiaries and affiliates. Getty Oil is not alone. States often experience such reporting of little or no income by large multistate and multinational corporations.

[illegible] In *Butler Bros. v. McColgan*, supra, the Supreme Court upheld formula apportionment of unitary income as reasonable even though apportioned income exceeded the income allocated by the taxpayer and by "separate accounting."

[illegible] *The President's 1978 Tax Reform Program*, pp. [illegible].

accounting — for the earnings of its various divisions. It did so on the ground that:

> *Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions.*[17]

The unreliability of the arm's-length standard has also been discussed by Professor Jerome R. Hellerstein in an article in the *National Tax Journal.* He points out that the unitary method was developed because:

> *. . . There is no viable way of separately accounting for the profits of a business where interdependent operating functions that produce the profits of the enterprise are carried on in more than one state.*[18]

And Zoltan M. Mehelay, at a recent U.S.C. tax institute, has noted the difficulties faced by both tax practitioners and revenue agents alike when they try to implement the arm's length method:

> *. . . The basic fallacy of the doctrine of the exclusive application of the arm's-length standard is that it is not true that evidence of the arm's-length prices can be obtained in every case. Indeed, probably in the majority of the cases, there is no evidence of truly comparable pricing arrangements involving unrelated parties.*[19]

The inability to apply the arm's-length standard has resulted, according to the *Harvard Law Review*, in the following:

> *. . .[T]here is evidence that the pricing test most often used by revenue agents to make allocations [arm's-length 482 adjustments] in routine international intercompany sales audits is the improvised fourth method [unitary method]. Indeed, one commentator has stated that it is the rule, not the exception, for agents in effect to view commonly-controlled businesses more as unitary than as separate entities.*[20]

When Mr. Nolan argues that the arm's-length standard is the worldwide norm, he neglects to mention the efforts of corporate lobbyists to make this method the world standard. I hope that both the states and the federal government set their tax enforcement aims higher than the international norm, which is not very high.

Mr. Nolan's real fear, pointed out in his November 27, 1977 letter to Dr. Walker, cited earlier, is that other nations will also adopt the unitary method. Authorities abroad are beginning to acknowledge its superiority. Brian Aungiers, an accountant with the London Branch of Peat, Marwick and Mitchell, wrote in a recent article that "the unitary method has considerable theoretical justification and may represent the wave of the future."[21]

The Rostenkowski Report

Mr. Nolan cites the so-called Rostenkowski Report as authority for the weaknesses of the unitary method. He neglects to mention that this report was based on the unsubstantiated allegations of particular multinational taxpayers. The Committee undertook no independent study of the merits of the arm's-length and unitary systems in actual practice. The Committee did not examine the tax returns of the witnesses to verify their allegations.

Furthermore, Mr. Nolan omits a key passage in that report which concluded:

> *. . . .[T]here is no significant disagreement that the states must use some type of apportionment formula [as distinguished from making an allocation of income and deductions by separate accounting], since there would be no practical way of determining what income of a company is earned within a state as opposed to being earned within other states [or in foreign countries.]*[22]

Will the Treaty Produce Substantial Benefits?

Mr. Nolan argues that the states should not oppose Article 9(4), because of the substantial benefits multinational taxpayers will get under other provisions of the treaty. This was, as indicated above, precisely the multinationals' strategy — to attempt to insure passage of Article 9(4) by holding other treaty provisions hostage to it. This strategy browbeats the states into supporting something against their interests — both in itself and as precedent — and paints members of the Senate who oppose Article 9(4) into the same corner. This sort of cunnning is an unacceptable way for resolving disputes within the federal system.

Mr. Nolan argues that multinational taxpayers stand to gain large sums under Article 10 of the treaty. But the British Government calls the U.S. Treasury's estimates of these benefits greatly inflated. In any event, these payments are supposed to benefit the states because dividends coming across the Atlantic will result in additional tax revenues. However, Mr. Nolan neglects to mention that foreign dividends are exempt from taxation in at least 19 states, including New York, Pennsylvania, Connecticut, Delaware, and New Jersey, where many multinational taxpayers are headquartered.

Conclusion

In conclusion, Mr. Nolan has not established that the United States Senate should now embark on an unprecedented mission and use the treaty process to curtail the reasonable and legitimate taxing powers of the states. Furthermore, Mr. Nolan has utterly failed to establish that the unitary method is in any way inferior to the arm's-length method or that the arm's-length standard is a viable taxing method for the states.

His claim that the arm's-length method is working well on the federal level and that the states therefore should trust their fate to the Internal Revenue Service is faulty in two respects. First, the Treasury Department's efforts to restrict state taxing powers by unilateral action through the U.K. Treaty hardly convinces the states that the Treasury Department has their interests at heart. Second, the arm's-length standard simply is inadequate. To hide this inadequacy behind other treaty provisions or to justify it on the basis of alleged worldwide practice does not salvage the position of Mr. Nolan and the Treasury Department. In the interests of economical and effective government, as well as fair play, Article 9(4) should be reserved from the U.S.-U.K. Tax Treaty.

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[17] Letter dated January 6, 1976, Appendix to Hearings.

[18] Hellerstein, XXI *National Tax Journal* 487, 500 (1968).

[19] 25 *U.S.C. Law Center Tax Institute* 731, 749 (1973); Cf. 28 *NYU Institute on Federal Taxation* 603, 613, 616-617; "Developments in Intercompany Pricing Under Section 482," *Seventh Annual Institute on International Taxation* 103 (July 16, 1976).

[20] 90 *Harvard Law Review* 1202, 1222 (1976).

[21] *Tax Planning International*, June 1977, p. 109.

[22] *Recommendations of the Task Force on Foreign Source Income, Committee on Ways & Means, U.S. House of Representatives, March 8, 1977*, p. 28.

Mr. Corrigan. Thank you.

Senator Mathias indicated that the Multistate Tax Commission is a small organization and decreasing in membership, and I would like to dispute that. We have 19 full member States and 12 associates, and I think that the extent of the opposition which the Multistate Tax Commission has experienced at the hands of many of the corporate representatives here today is some indication of the importance of our work. We maintain that we are making substantial progress toward improvements in uniformity, perhaps not enough, but certainly substantial progress.

I think it is important to note here that all the comments concerning double taxation have always made reference to potential, never to actual, double taxation, and the Supreme Court has had occasion to comment on that in recent cases, including the Moormon case.

I think it is also interesting that so many corporate representatives have been willing to come up here and to testify in favor of something which is going to reduce their taxes. I suppose we could all testify against ourselves being taxed.

The statement was made that Mobil's tax in Vermont had been raised 10 times as a result of the Supreme Court case. Actually, it was more than 40 times, which to me is shocking in itself. The entire tax paid by Mobil over a 3-year period in Vermont was $1,800. That just is shocking in comparison to the overall profits made by these companies.

In some quarters, I am afraid that these bills that we are discussing are considered to be oil company relief acts. It seems to be strange in the year when the windfall profits tax has been enacted. That was for the benefit of the Federal Government. These bills would be at the expense of the States, a rather strange counterplay.

The Multistate Tax Commission was formed to keep the Federal Government from getting into the State's bailiwick, from enacting restrictive legislation. I perceive a change in the position of our member States to the extent that most of them do not necessarily oppose all Federal legislation, but they oppose bad Federal legislation such as is proposed here. I think that, if a good bill were proposed, many of the States might support it. Such a bill would have to attack the problems of nonuniformity by proposing some uniformity, some cure.

What we have here are allegations of problems, for which the cure allegedly is to give relief from what is, in many cases, mythical taxation of these big corporations. That doesn't seem proper to us.

Senator Mathias has spoken about the writers of the Constitution being concerned about the burden on commerce. This bill would not relieve a burden on interstate commerce. What it does, really, is to create an advantage for interstate, international commerce over intrastate commerce. That is just exactly the opposite of what the writers of the Constitution were concerned about.

They were concerned that intrastate commerce not be favored over interstate. These bills reverse that situation. You have heard talk of foreign income today, but foreign income is a matter of definition. If you can run income earned here through a foreign tax haven and bring it back as exempt dividends, is it foreign income?

This is the sort of thing we have to cope with, and it is a dangerous situation. You have also heard assertions that the Mobil and Exxon situations, where they are paying virtually no tax to these States, were unusual. I submit to you, Senator Byrd, that that is not the case. They are common cases, all too common. The States have great amounts of money at stake here, and that we should be concerned about it.

The Supreme Court has said that you cannot determine by separate accounting the amount of income earned in a particular State. You must use apportionment.

John Rowe in some of his writings has referred to a baseball pitcher—I think he was talking about Ron Guidry at the time—and questioning whether you could attribute his prowess to his arm, to a leg, or to his head. The major corporations and conglomerates are similar in nature.

The Supreme Court has said that the unitary business concept is the lynchpin of apportionability. They said, you have to use apportionment to arrive at some reasonable estimate of the amount of money earned in a State, and that the unitary concept is the lynchpin of it. We submit that it should not be threatened or destroyed through such legislation as you have here.

Finally, Ms. Borken-Hagen earlier referred to the States as political subdivisions of the Federal Government. I don't want to belabor the issue, but I do submit that if this legislation does pass, then great steps will have been taken toward converting the States into just that, political subdivisions of the Federal Government.

Thank you, Senator.

Senator BYRD. Thank you, Mr. Corrigan.

Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT SUBMITTED TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE BY THE EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

FOR A HEARING ON S. 983 AND S. 1688 HELD ON JUNE 24, 1980

The Executive Committee of the National Association of Tax Administrators, an organization of the state revenue departments of the 50 state governments and the District of Columbia, respectfully requests the Subcommittee on Taxation and Debt Management of the Senate Finance Committee to take no action on S. 983 and S. 1688.

S. 983 deals with state sales and use taxes, gross receipts taxes, and corporation income taxes on both domestic and foreign source income. S. 1688 deals with foreign source income only. Both bills would limit state taxation without recognition of the uniformity in tax law achieved by the states, the judicial protection provided multistate and multinational taxpayers under existing federal and state law, and without consideration of the need to expand state taxing jurisdiction in certain sales and income tax areas in order to protect local business against discrimination and state and local governments against the loss of much needed revenue.

The NATA Executive Committee, as it always has, stands ready to assist Congress in developing solutions to problems in interstate taxation. Its objections to S. 983 and S. 1688 may be summarized as follows:

(1) The bills would restrict state taxing authority, interfere with the long-standing division of federal and state taxing powers, establish a precedent for further adverse action against the states, and reduce state revenue.

(2) The bills would inflict these losses on the states without compensating them by correcting existing federal restrictions on state taxation of interstate transactions which result in discrimination against local business and in the loss of revenue to state and local governments.

(3) The bills disregard the substantial uniformity the states have achieved in their income and sales taxation of interstate transactions. They would impose new restrictions on the states in areas of taxation where uniform provisions are prevalent and where the courts have stated that multistate and multinational taxpayers have judicial protection against discriminatory treatment.

(4) In their provisions relating to foreign source income, the

bills would require the states to adopt a separate accounting procedure, the arm's length method, which has been subject to widespread criticism and could result in major compliance and auditing problems.

(5) Passage of the bills at this time, when a General Accounting Office study of state income taxation of multijurisdictional business, authorized by Congress, is in process, would negate the value that such a study is intended to have.

(6) The bills conflict in a number of areas with the NATA Policy Statement on the Taxation of Interstate Business, a set of principles adopted by the states in 1979. The principles in the NATA Policy Statement are designed to balance state and taxpayer concerns in the taxation of interstate and multinational income. They reflect the willingness and desire of the state tax administrators to cooperate with Congress in solving state and taxpayer problems in interstate taxation in a form which would provide equity for both local and multistate taxpayers and permit the effective and equitable administration of state taxes.

Uniformity in State Taxation of Interstate Business

The states have taken important legislative and administrative action to promote tax uniformity and simplify tax compliance, with impressive results. A review of these achievements is relevant to an understanding of why state tax administrators oppose the restrictive provisions of S. 983 and S. 1688. Some major aspects of the states' tax simplification efforts are as follows:

Corporation Income Tax Base: Thirty-four of the 45 states imposing corporation income tax laws have adopted the federal tax law as the starting point for determining taxable income for state tax purposes, by specific reference to the Internal Revenue Code. Most of the remaining states have adopted provisions which correspond to federal law so closely that, in practical effect, they equate the starting point laws. This means that, in a substantial measure, any difficulties which confront a corporation in reporting state income tax actually occurs in the preparation of the federal rather than the state tax return.

Standard Apportionment Formula: Twenty-eight states and the District of Columbia have adopted verbatim, or with some modifications, the Uniform Division of Income for Tax Purposes Act promulgated by the National Conference of Commissioners on Uniform State Laws. Most of the remaining states have apportionment formulas which correspond closely to the UDITPA formula, and all but three states imposing corporation income taxes use a three-factor formula.

Credit for Sales or Use Tax Paid to Another State: Of the 45 states and the District of Columbia imposing sales and use taxes, all but one allow a credit for a sales or use tax paid another state. Only two states have any limitations in this regard. In each of the 42 states and the District of Columbia, the credit is given for sales taxes paid to all states without restriction.

State Collection of Local Sales Taxes: Of the 26 states in which local governments impose sales taxes, in all but six, local sales taxes are collected entirely by the state government. In 20 states, an out-of-state business files only a single combined return with the state government covering both state and local sales and use taxes. In two of the remaining six states, the majority of local sales taxes are paid to the state.

Exemption and Resale Certificates: Each sales and use tax state, by statute or regulation, provides that a vendor who receives and accepts a resale certificate in good faith shall be relieved of responsibility for sales tax on such a transaction unless it is obvious that the property involved is not being acquired for resale.

Discrimination Against Interstate Transactions: Discrimination of this type has been completely eliminated. There are no known instances of states which discriminate against interstate business by treating differently, for sales tax purposes, transportation charges on intrastate and interstate sales.

Charges for Expense for Out-of-State Audits: Based on available information, there is no state which now charges taxpayer corporations for the expense of an out-of-state audit. The few states which at one time required the taxpayer to reimburse the state for the cost of sending an auditor to the taxpayer's out-of-state location to make a sales or use tax or corporation income tax audit have repealed this requirement.

Extended Filing Period: In all but a few states, interstate vendors whose sales within a state are minimal may be granted permission to file returns at less frequent intervals than the basic monthly or quarterly requirement.

In view of the near universality of the above provisions, the NATA Executive Committee views legislation such as S. 983 as unnecessary because the remedies sought by interstate taxpayers for greater simplicity in compliance are predominantly already in state tax statutes.

Judicial Protection for Multistate and Multinational Taxpayers

Testimony presented in support of the income tax provisions of S. 983 and S. 1688 has often disregarded the substantial uniformity in state corporation income tax laws. Instead, it has been asserted that multistate and multinational corporations are subject to double taxation because of diversity in state income tax laws. In actual fact, uniformity is widespread, and multijurisdictional business, like other taxpayers, has recourse to the courts in protesting an assessment on the grounds of excessive taxation.

S. 1688, the bill relating to foreign source income only, has been proposed on the basis that such legislation was needed to protect multinational business from double taxation by the states. The U. S. Supreme Court, in Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S.___(1980), specifically rejected this argument. The court stated as follows:

> ...appellant's argument underestimates the power of this Court to correct excessive taxation on the field where appellant has chosen to pitch its battle. A discriminatory effect on foreign commerce as a result of multiple state taxation is just as detectable and corrigible as a similar effect on commerce among the States. Accordingly, we see no reason why the standard for identifying impermissible discrimination should differ in the two instances.

Restricting State Taxing Powers

The states are deeply concerned over any federal action which would curtail their taxing authority. They have two principal concerns in this regard, which may be summarized as follows:

> (1) Most state budgets are tightly balanced, especially at the present time because of the impact of recession on tax collections, voter-directed tax reduction, and the loss of federal revenue sharing funds. Even the loss of a small amount of revenue can create fiscal difficulties for the states. Necessarily, the states view with apprehension any federal action which, in itself or as a precedent, could serve to diminish state revenues.
>
> (2) In the past fifteen years, the states have been confronted by proposals which would limit their taxing authority, impair taxpayer equity, and adversely affect their ability to administer their taxes. The states have had to address themselves to congressional bills which would create loopholes in state income tax law and would seriously affect sales and use tax enforcement by restricting their authority to impose use tax collection requirements on out-of-state vendors. Congress has recognized the states' position on these issues and has taken no action on the proposals.

Some of the more prominent restrictions on state taxing authority in S. 983 and S. 1688, in combination or individually, are the following:

- --prohibiting the use of the unitary method in taxing foreign source income,
- --limiting the states' ability to tax foreign source dividends,
- --excluding "throwback" or "throwout" provisions in corporation income tax laws, now relied upon by the states to prevent the assignment of income to nontaxing jurisdictions,
- --establishing a jurisdictional standard for the imposition of state and local sales and use taxes that is more restrictive than the prevailing standard,
- --imposing certain sales and use tax requirements which would jeopardize effective sales and use tax administrations,
- --restricting the states' ability to impose gross receipts taxes through a narrow jurisdictional standard, and
- --requiring that state and local tax determinations be reviewed by the federal courts.

These restrictions may be explained as follows:

Unitary Method: S. 983 and S. 1688 would curtail state taxing authority by barring the use of the unitary method in taxing foreign source income, a method employed by some states. States point to the fact that the unitary method has long been upheld by the courts and is regarded as a reasonable means for apportioning corporate income. Concern has been expressed that a bill such as S. 1688, even though limited to foreign source income, if passed, would establish a strong precedent for the restriction of state taxing authority in other areas, at the expense of state administrative effectiveness and state tax equity.

S. 983 and S. 1688, by barring the use of the unitary method, would compel the use of the arm's length method, a separate accounting procedure, by any state which finds it necessary to adjust transactions among international affiliates to determine the state tax base. States which have been confronted with the problem of arm's length method express grave doubts as to whether this method can be effective.

This view is not confined to state tax administrators. An extensive note in the Harvard Law Review, April 1976, detailed the problems involved in applying the arm's length method and concluded that serious consideration should be given to the use of the unitary entity theory as a formalized alternative to current practice.

The difficulties inherent in the use of the arm's length method are also noted in the Committee on Ways and Means, U.S. House of Representatives Recommendations of the Task Force on Foreign Source Income (March 8, 1977). In discussing the arm's length method provided by federal law, this report states as follows:

> This approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).

Treatment of Dividends: S. 983 and S. 1688 would impose important limitations on the states' ability to tax foreign source dividends. The NATA Executive Committee supports the position of the U.S. Treasury opposing the provisions of S. 1688 relating to state taxation of foreign source dividends. The provisions of S. 983 on the taxation of foreign source dividends, in their effect, correspond to those in S. 1688.

The bills' limitation on dividend taxation would result in a widespread revenue loss for the states and would discriminate against corporations investing in the United States and favor those investing in foreign countries.

Forty-four states impose corporation net income taxes. Of these states, two-thirds tax dividends received from foreign corporations. Each of these states would lose much-needed revenue as a result of the limitations in S. 1688.

The restrictions imposed by S. 1688 on state taxing power would result in a full exemption of dividends received from some foreign corporations and a partial exemption of dividends received from other foreign corporations. In contrast, state taxes would be paid in full by corporations receiving dividends from domestic corporations.

In addition, the formula in the bill for determining the dividend exclusion has serious technical flaws which would serve to diminish the amount of foreign source dividends a state could tax.

Excluding "Throwback" and "Throwout" Provisions: The exclusion of a "throwback" or "throwout" provision from the sales factor to which a state would be required to adhere under Sec. 357 of S. 983 is a departure from the Uniform Division of Income for Tax Purposes Act and is widely regarded by state tax administrators as a means for allowing properly apportionable corporate income to escape taxation. With respect to sales destined for a state which is deprived of jurisdiction to impose an income tax on a seller by P.L. 86-272, the "throwback" rule would assign the sale to the state of origin; a "throwout" provision would eliminate the sale from both the numerator and denominator of the sales fraction. Either approach would assure full accountability of sales, a concept long supported by tax administrators and one which has had growing acceptance by business taxpayers.

Sales and Use Tax Jurisdictional Standard: In its sales and use tax provisions, S. 983 is an improvement over interstate taxation acts proposed in recent years in that it codifies the U.S. Supreme Court's decisions in the *General Trading*[1] and *Scripto*[2] cases, which uphold the states' authority to require the collection of use tax by out-of-state vendors represented in the taxing state by salesmen and solicitors. Interstate taxation bills introduced in 1977 and earlier years would have repealed the *General Trading* and *Scripto* rules, giving out-of-state vendors a substantial and unfair competitive advantage over local merchants and causing a serious loss in state and local sales and use tax revenues.

In its present form, however, S. 983 still imposes restrictions on the jurisdiction of state and local governments to impose sales and use taxes. With respect to local governments, an example of a

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[1] *General Trading Co.* v. *State Tax Commission*, 322 U.S. 335, 64 S. Ct. 1028

[2] *Scripto, Inc.* v. *Carson*, 362 U.S. 207, 80 S. Ct. 619

best copy available

restriction which would adversely affect sales tax equity and revenues is the provision prohibiting a political subdivision from requiring the collection of sales or use taxes by a person not present in the jurisdiction either through a business location, or salesmen or solicitors, or who does not deliver goods into the political subdivision except by common carrier or by the U.S. Postal Service. Under this provision, a mail order seller present in the state with a business location and making a large volume of sales throughout the state can make such sales free of local tax except in those localities in which it has a business location. The restriction would give such a mail order seller a distinct competitive advantage over local merchants who would be required to collect local sales taxes on their sales.

Sales and Use Tax Requirements: S. 983 contains various sales and use tax requirements which may adversely affect state and local revenues and local business, or which constitute a restriction of questionable purpose in view of the uniformity or near-uniformity of state practices in this regard.

Freight Charges Incident to Interstate Sales: Based on available information, there is no known instance of a state discriminating against interstate sales with respect to the inclusion of freight charges in the sales tax base. In a substantial number of states, the effect of Section 101(c) in S. 983 would be to discriminate against *intrastate* sales, since freight charges on the purchase and delivery of goods within the state would continue to be subject to tax while freight charges on interstate sales would be exempt.

Sales to Registered Business Purchasers: The use of registration number procedures provided in Section 103 of S. 983 as a substitute for vendor collection would mean that state revenue departments would have to collect sales or use tax from a large number of buyers, instead of a relatively small number of vendors as is provided under current state law. The requirement would open new avenues of tax evasion because the states' ability to audit each registrant is necessarily limited. Similarly, it would be of questionable value to the purchaser who, it would appear, would find it simpler to pay the tax to the vendor at the time of purchase.

Exemption Certificates: As has been noted previously in this statement, each state relieves a vendor who received a resale certificate in good faith from the responsibility of collecting sales tax on this transaction. Many states are concerned that the language of Section 103 in S. 983 would weaken the "good faith" requirement and would be an invitation to misuse the exemption certificate for tax evasion purposes.

Certification of Tax by Purchaser: State tax administrators have expressed concern over the administrative difficulties which may arise from the election provided in Section 104 of S. 983. Section 104 authorizes certain sellers, in lieu of collecting a state or local sales or use tax, to collect a combined state and local sales or use tax at a rate certified by the purchaser as the correct rate. In the absence of a combined uniform rate, the state tax administrators are concerned that, instead of simplified administration, this provision could result in large scale supplemental billings or refunds to purchasers, and that the need to follow up the certified rate could complicate both administration and compliance.

Gross Receipts Taxes Uniform Jurisdictional Standard: While only a few states impose gross receipts taxes, they would strongly oppose a federal statutory provision, such as Section 201 of S. 983, which would establish a jurisdictional standard based on a business office in the taxing state or political subdivision and would have the effect of negating the *Standard Pressed Steel*[1] rule. It may be noted that the U.S. Supreme Court handed down a unanimous decision in the *Standard Pressed Steel* case, upholding the state's right to tax based on the presence of an employee, but not a business office, stressing the protection and benefits received by the taxpayer through its ability to do business in the state. The effect of Section 201 would be to permit out-of-state businesses to enjoy such benefits free of tax while local businesses were subjected to tax.

Jurisdiction of Federal Courts: State revenue departments object to provisions in Title IV of S. 983 which would place in the federal courts issues involving state and local tax determinations.

Losses to the States Without Compensation

The U.S. Supreme Court, in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 87 S. Ct. 1389, ruled that a state could not require an out-of-state mail order company to collect use taxes on sales to the state's residents when its only activity in the state was the solicitation of sales by mailed catalogues and delivery by mail and common carrier. This ruling, in practical effect, enabled out-of-state mail order companies to sell their goods in a taxing state free-of-tax. Thus it gave such companies a competitive advantage over local merchants and deprived the state of taxes on such sales.

In addition, the states' lack of jurisdiction over out-of-state vendors permits such vendors to exploit markets in states other than that in which they are located through use of advertising media and to make a substantial volume of sales in those states with no requirement that they collect taxes on such sales.

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[1] *Standard Pressed Steel Co.* v. *Department of Revenue*, 419 U.S. 560, 95 S. Ct. 706.

Through federal legislation, the states' jurisdiction to require out-of-state sellers to collect sales or use taxes on sales into a taxing state could be expanded so as to protect local merchants from tax-free competition and prevent the loss of state and local revenue which now occurs. State tax administrators, in considering S. 983 and S. 1688, have found it highly inequitable to seek solutions to multijurisdictional business tax problems while disregarding the states' need for more taxing authority in order to protect local business and make their tax systems operate more effectively and equitably.

The NATA Policy Statement on Interstate Taxation

NATA, at its 1979 Annual Meeting, adopted a Policy Statement on the Taxation of Interstate Business, a statement, as noted, designed to balance taxpayer and state tax agency concerns in the taxation of interstate and multinational income. The statement has as a principal purpose the mandating of a method for determining an income ceiling for the taxation of income by any state. The statement is recognized as a significant effort by states to identify a common set of rules for the taxation of interstate income. It was drafted by NATA in the event that Congress should determine that federal legislation in this area was necessary.

In approving the statement, the state tax departments comprising NATA's membership stressed that it reflects compromises by all states and is an integrated consensus of the states and that, if the statement were fragmented or unbalanced, it could no longer be represented as the collective position of the states.

The NATA Executive Committee wishes to point out that, in developing a set of principles for interstate income taxation, the following principle was adopted with respect to sales and use taxes:

A. No federal legislation affecting state corporate income taxation should be considered without inclusion of provisions which improve and clarify state sales and use tax jurisdiction.

B. If Congress desires to address this area, it should be directed to:

   1. Codification of existing jurisdictional standards as reflected in court decisions such as General Trading and Scripto; and

2. Providing power to the states to tax out-of-state vendors which otherwise escape state and local sales and use taxes, thus protecting small local businesses from tax free competition. If it is found necessary to provide for geographic accounting, then it should be on the basis of one rate per state, applicable to out-of-state vendors not included in the jurisdiction of 1., above.

In conclusion, for the reasons stated above, the Executive Committee of the National Association of Tax Administrators urges Congress to take no action on S. 983 and S. 1688 and it reiterates its willingness and desire to discuss the issues involved with Congress.

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS
Executive Committee

Position Paper*
on the
INTERSTATE TAXATION OF BUSINESS

The Executive Committee of the National Association of Tax Administrators is opposed to federal restrictions on the states' taxing authority. However, if the Congress concludes that legislation on the interstate taxation of business should be enacted, state tax administrators urge it to adopt and follow the principles set forth below:

I. Income Taxes

A. General Requirements

1. Legislation should mandate a method for determining an income ceiling for state taxes on or measured by income, but should not preclude any state from utilizing any method for determining the income attributable to it so long as the ceiling is not exceeded.

2. Any legislation should include a phase-in period to allow the states to adjust existing state laws if necessary. The recommended period is six years to accommodate states with biennial legislatures and to allow the governors of the states sufficient time to develop a coordinated program to implement necessary changes.

3. Legislation should be limited to those particular industries where the standard three-factor formula is generally conceded to properly apportion income, including, but not limited to, mining, manufacturing, retail and wholesale trading.

4. Because of the unique character of the business of oil and gas extraction, it should not be subject to a ceiling limitation where a state finds that a particular method of accounting is necessary to properly reflect the activities of the business within its boundaries.

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* Adopted by the Executive Committee at a special meeting held on March 19, 1979, in Chicago, Illinois.

5. Legislation should limit only the measure of taxation of the described businesses and should in no way limit the states' ability to tax corporations in other businesses.

6. Legislation should apply only to income taxes or taxes measured by income and should not apply to severance, gross receipts, capital, or other similar taxes.

7. The states should retain authority to determine the income of an individual corporation pursuant to a combined report or consolidated return which could include corporations and activities not otherwise affected by the act.

8. There should be no limitation on a state's ability to utilize the worldwide income and activities of a business in determining the income taxable in a given state.

9. Any legislation should be prospective in nature only.

10. The legislation should be formulated to ensure full accountability by corporate taxpayers and should not result in the allocation or apportionment of income to jurisdictions or geographic areas where the business is not taxable.

11. Nexus or taxability should be determined on the basis of U.S. standards, both constitutional and statutory, regardless of whether the activities are carried on within or without the U.S.

12. Any future proposed legislation should be subjected to full hearings before the House Committee on Ways and Means and the Senate Finance Committee.

13. Any legislation which is enacted should be self-executing and should not require any additional state agency for administration beyond existing state tax departments, nor should any existing or new federal agency be assigned any administrative authority now vesting in any state tax department.

14. Any appeal procedure provided for shall be through existing state administrative or judicial appeal systems.

B. For Purposes of Determining the Ceiling Limitation the Following Rules Should Apply:

1. Income

   a. The states should not be restricted in determining their own income base.

b. Characterization of income, such as business or non-business, should be determined under the laws of the individual states.

c. Business income should be apportioned by an equally weighted three-factor formula consisting of property, payroll, and sales which give rise to business income.

d. Nonbusiness income should be allocated, in the case of real and tangible property, to the location of such property and, in the case of intangible property, to the business situs of the property or the owner's commercial domicile.

2. Property Factor

a. Property should be valued for factor purposes at original cost.

b. Rented property should be capitalized and included in the property factor.

c. Only property which is used or available for use in the business should be included in the factor.

d. Intangible property should not be included in the factor.

e. Movable property should be allocated to the states on the basis of time or mileage, or such other factors as is determined by the individual states.

f. Property which is in transit should be assigned to its destination.

g. Intangible drilling costs are to be included in the property factor at a state's option regardless of whether such costs are capitalized or expensed.

h. Property values should be determined on the basis of a beginning/ending year average unless a state determines that an alternative basis should be used to properly reflect values.

3. Payroll Factor

a. Compensation should include wages, salaries, commissions, and any other form of remuneration paid or payable to employees for personal services.

b. Payroll should be assigned to a state based upon where the services are performed or where the employee's activities are controlled.

4. Sales Factor

   a. Sales should be assigned on the basis of destination, except U.S. Government sales to NASA or the Department of Defense which should be assigned to the jurisdiction from which the product is shipped.

   b. The sales factor should be limited to those receipts which arise from the taxpayer's business activities. Receipts derived from intangibles, even though constituting business income, will normally be excluded from the sales factor, as will receipts from the occasional sale of assets.

II. Sales and Use Taxes

A. No federal legislation affecting state corporate income taxation should be considered without inclusion of provisions which improve and clarify state sales and use tax jurisdiction.

B. If Congress desires to address this area, it should be directed to:

   1. Codification of existing jurisdictional standards as reflected in court decisions such as General Trading and Scripto; and

   2. Providing power to the states to tax out-of-state vendors which otherwise escape state and local sales and use taxes, thus protecting small local businesses from tax free competition. If it is found necessary to provide for geographic accounting, then it should be on the basis of one rate per state, applicable to out-of-state vendors not included in the jurisdiction of 1., above.

C. Any federal legislation dealing with sales and use tax should not restrict the states' right to determine the measure of the sales tax or the nature of transactions to be taxed. For example, legislation should not concern itself with whether or not transportation charges should be included in the measure of tax, nor should it dictate whether sales to certain entities are taxable.

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS
ADVISORY GROUPS TO THE PRESIDENT

Income Tax

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STATE OF CALIFORNIA

FRANCHISE TAX BOARD

STATE TAXATION OF INTERSTATE BUSINESS
SENATE BILLS 983 AND 1688 96TH CONGRESS
POSITION PAPER

HEARING BEFORE THE
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

WASHINGTON, D.C.
JUNE 24, 1980

Summary of Franchise Tax Board
Position Paper on S. 983 and S. 1688

The Franchise Tax Board of the State of California, along with all 23 other states which testified, the Multistate Tax Commission and the National Association of Tax Administrators, was opposed to S. 2173, which was introduced in the 95th Congress by Senator Mathias. Title III of S. 983 with two amendments is identical to Title III of S. 2173. The Franchise Tax Board's opposition continues.

S. 1688, while less comprehensive in approach than S. 983, is subject to the same fundamental defects and is opposed by the Franchise Tax Board.

Both bills would cause significant reductions in state revenues, the benefits of which would inure principally to multinational business. Estimates of this loss total at least three-fourths of a billion dollars for just six states. The states would have to recover the lost revenue someplace. This added burden would necessarily be shouldered by small businesses and individuals.

Both S. 983 and S. 1688 are based upon defective and ill-advised tax policies. The defects in the approach taken by S. 983 were detailed in the Franchise Tax Board's testimony on S. 2173. Three major defects, however, require further commentary.

S. 983 and S. 1688 exclude from the states' tax base so-called "foreign source" income. The states do not tax foreign source income and in fact are prohibited from taxing any income which is not attributable to activities or sources within their individual boundaries.

The federal government is not limited to taxing income from particular geographic sources as the states are. Consequently, federal experience in making geographic source determinations is more limited than the experience of the states. The method the states have developed, the unitary method, has proved effective and has withstood the tests of judicial review, administrative practicality and time. It should not be abandoned in favor of the arm's-length standard used by the federal government which has been the subject of widespread criticism. A Congressional Task Force on Foreign Source Income, the Harvard Law Review, the Journal of Taxation, the Harvard Business Review and the Treasury itself, among many others, have criticized the arm's-length standard and have recognized the impracticality of using it for state purposes.

The treatment of dividend income by S. 983 and S. 1688 is based upon the faulty premise that its geographic source is determined on the basis of the payor's activities. As recently as March of this year, the United States Supreme Court rejected this position and held that the treatment of such income is governed by the recipient's activities.

S. 983 does not require full accountability. The apportionment formula proposed in the bill establishes tax havens for corporations, allowing them to apportion income to jurisdictions which are prohibited by federal statutes or constitutional constraints from taxing such income. Why should a tax preference be created for income assigned to tax havens?

The General Accounting Office is currently studying the issues involved in state corporate income taxation. The GAO should be requested to obtain corporate tax returns and determine whether there are instances of multiple tax burdens as claimed by business. Furthermore, any abandonment or restriction on the states' use of the unitary method should only be considered after the GAO has completed its study and report on the effectiveness or defectiveness of the arm's-length standard. A proven method should not be replaced by an unproven and unadministerable method.

The Franchise Tax Board of the State of California is opposed to S. 983 and S. 1688 and recommends that this committee reject both bills.

California State
Franchise Tax Board

State Taxation of Interstate Business
96th Congress
Senate Bills 983 and 1688

Position Paper

Hearing Before the
Subcommittee on Taxation and Debt Management
of the Committee on Finance
United States Senate

The Franchise Tax Board of the State of California is charged with the duty of administering the Bank and Corporation Tax Law of California. This law asserts both a Franchise Tax which is measured by income and a Corporate Income Tax. Since the Board's only area of concern is the area of so-called net income taxes our remarks are restricted to Title III of Senate Bill 983 and Senate Bill 1688.

During the Ninety-Fifth Congress, the Senate Judiciary Committee held a series of hearings on Senate Bill 2173 which addressed the question of state taxation of interstate commerce. This bill was comprehensive in nature, addressing sales and use taxes, gross receipts taxes, and capital stock taxes as well as net income taxes. The hearings began in December of 1977 in Biloxi, Mississippi, and concluded in December of 1978 in San Francisco, California. A printed record of over 950 pages resulted from these hearings.

During these hearings, representatives of at least 23 states and both the Multistate Tax Commission and National Association of Tax Administrators express their opposition to that bill. Not a single state testified in favor of it.1/

In spite of this opposition, expressed without exception by both the states and their representative groups, Title III of S. 2173 has been carried forward in the current bill, S. 983, with only two substantive modifications.2/ These modifications, which are not insignificant, eliminated a one-sided election as to consolidation or combination and prevented the inclusion in the apportionment formula of factor elements related to income specifically excluded from the apportionable base. These modifications, however, deal solely with the redress of what were blatant inequities favoring the business community; they do not deal with the fundamental defects in the approach taken by Title III. Therefore, in spite of the changes, the Franchise Tax Board remains opposed to S. 983, and we believe all other states remained opposed to it.

S. 1688 deals with a single narrow issue in the field of state income taxation; i.e., what income and entities are to be included in the apportionable base? This issue is also covered in S. 983. We are also opposed to S. 1688 and believe that all of the states likewise join us in opposing this bill. Neither S. 1688 nor its House of Representatives' companion, H.R. 5076, meet any of the requirements for federal legislation which were established by the states and set forth in a position paper unanimously endorsed by the National Association of Tax Administrators in June of 1979 (Attachment 1). It should also be noted that S. 1688 reinstates the one-way election which the authors eliminated from S. 983 after the states objected.3/ It limits the states' taxing powers, but gives the states absolutely nothing in return.

What S. 983 does do is take from state treasuries and give to multinational corporations. While not all states have prepared estimates of the revenue impact of Title III of S. 983, the magnitude of the big business benefit/state tax loss can be ascertained by a review of the testimony offered on the predecessor bill, S. 2173. The state of Indiana estimated a revenue loss of $40 million on the throwback issue alone,4/ Minnesota estimated a loss of $56 million for Title III III,5/ Utah--$15 million,6/ California--$485 million. (Attachment 2.) The state of West Virginia estimated a loss of $110 million on the gross receipts tax 7/ and pointed out that it collects the higher of the alternative of the gross receipts or income tax. Clearly, no portion of the $110 million will be recovered through the income tax, suggesting a significant loss through Title III. The state of Alaska, during the hearings held by the Senate Foreign Relations Committee on the United States - United Kingdom Tax Treaty, projected a loss of $50 million for the oil industry alone for an exemption similar but more limited than that proposed by S. 983.8/ Based on these six states alone, the revenue loss to the states just in the income tax portion of the bill approaches three-quarters of a billion dollars. What would the total loss be for all states asserting an income tax? Even though it is a much less complex bill, S. 1688 will create similar losses.

Even more damaging than the dollar losses involved, however, are the ill-advised tax policies which these bills represent. These bills would establish a tax preference for multinational corporations and would result in the further shifting of tax burdens to local businesses and individuals. The only taxpayers which would receive a benefit under these bills are those which conduct business activities, whether conducted by a single corporation or through affiliates, in foreign countries.

In conjunction with its appearance before the Senate Committee on the Judiciary on December 20, 1978 in San Francisco, the California Franchise Tax Board submitted a position paper which set forth the numerous defects of Title III and provided specific examples of the large-scale state tax avoidance which would be effectively sanctioned by enactment of S. 983.9/ Little purpose would be served by resubmitting this position paper in its entirety since it is readily available in the printed record of the proceedings. The examples and objections set forth in that paper, however, retain their vitality and are almost without exception as valid under Title III of the current bill as they were under its predecessor.

There are, however, three fundamental defects in Title III, which must be discussed again. These three defects are: (1) the exclusion of so-called "foreign source income" from the apportionable base; (2) the treatment of dividend income; and (3) the lack of full accountability. The first two items are also incorporated in S. 1688. Each of these three defects was either specifically mentioned or alluded to by each of the states which testified against S. 2173. Yet the objections of the states are in no way reflected in S. 983's treatment of these items.

Title III, of S. 983 eliminates so-called "foreign source income" from apportionable income in two separate places. First, the last clause of Section 302 provides "no foreign source income of such taxpaying corporation shall be apportionable or allocable to any state" and second, Section 303(b)(2) prohibits the inclusion in a combination or consolidation of "any corporation substantially all the income of which is derived from sources without the United States." Source determinations are made under the Internal Revenue Code. S. 1688 prohibits the states from including in a combined report any amount of income attributable to any foreign corporation unless the income qualifies as Subpart F income, i.e., income which is deemed to be properly attributable to the United States.

The justification offered for these provisions is premised upon the faulty assumption that the states are taxing income earned outside their borders and outside the borders of the United States. The proponents of S. 1688 and Title III of S. 983 are attributing powers to the states which they do not have. The states, in assessing taxes on or measured by income of a nondomiciliary corporation, are limited to income from sources within their boundaries pursuant to the due process clause of the Constitution.10/ This is true whether we are talking about a single corporation with activities in two states or a multicorporate business with activities in fifty states and one hundred countries. The principle involved is identical. A state may only tax that income which is attributable to activities conducted within its boundaries.

The federal government, however, is not so constrained. It may tax all the income of domestic corporations. The states are directly and primarily concerned with the determination of the geographic source of income while in the federal system the determination of the geographic source of income is only of peripheral concern. The states have, by necessity, wrestled with the question of the geographic source of income for well over 60 years. Approaches have been developed through trial and error and have been tested in the crucibles of time, administration, compliance and judicial review. The system which has evolved is commonly referred to as the "unitary method" and is based on the precepts of formula apportionment and combined or consolidated reporting. The approach to geographic source determination set forth in the Internal Revenue Code, however, has not been subjected to close review because the resolution of this problem is not of central importance to the functioning of the federal system. Yet, Title III would abandon the well-tested methods used by the states in favor of the basically untested federal method.

The unitary method has been accepted by all states in its most rudimentary form, formula apportionment, and is now employed by most states in its full form, including combined reporting.11/ At the time of the United States-United Kingdom Treaty debates, it was claimed that only California, Alaska, and Oregon were applying the unitary method to its fullest extent. There are now at least six other states which have judicial decisions upholding the inclusion of what the proposed bill treats as "foreign source" income in the state apportionment base (Montana, Idaho, New Jersey, Vermont, Illinois, and Maryland).12/ Furthermore, several corporations have given their full support to use of the worldwide combined report (Attachment 3).

The courts have never rejected the unitary concept. As recently as March 19, 1980, the U. S. Supreme Court again supported the unitary concept as applied to worldwide activities in Mobil Oil Corp. v. Vermont,13/ and on June 10, 1980, the Court approved Wisconsin's use of the unitary method in Exxon v. Wisconsin.

The reason the states found it necessary to develop the unitary method is the alternative, the arm's-length method, does not work. State tax administrators have long recognized this fact. In March of 1977 a Task Force appointed by the House Committee on Ways and Means, commenting on separate accounting, stated:

> This approach already produces significant problems when applied at the Federal level

> and would be virtually *impossible* to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).14/ (Emphasis added.)

Even Treasury has finally recognized the deficiency in separate accounting, particulary at the international level. It stated in supporting one of the elements of the President's 1978 Tax Program:

> The arm's-length standard is a necessary and valuable tax measure, but *it is sometimes difficult to administer*: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation, U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the *resultant loss of U. S. tax revenues can be substantial*.
>
> * * *
>
> Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. *But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing*. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.15/ (Emphasis added.)

The full text of Treasury's analyses, which covers both separate accounting and the fallacy of excluding so-called "foreign source" income from taxation, is set forth in Attachment 4 and includes many of the arguments the states have set forth in support of the unitary method.

As an illustration of the deficiencies of the arm-length standard, we would like to again set forth a single classic example. For years, United States-based drug manufacturers have conducted research and development operations in the United States but have manufactured the drugs which are sold in the United States in Puerto Rico. On the books of these companies, the profits were realized on the manufacturing process in Puerto Rico and, therefore, were not subject to United States tax. None of the research and development costs were charged to manufacturing drugs, so United States profits were miniscule. Additional liabilities in the amount of $22,000,000 have been asserted against Eli Lilly for the years 1971-73. G. D. Searle has already settled similar adjustments with the Internal Revenue Service, paying additional taxes of $16 million. The Puerto Rican tax haven has existed since 1939, and will continue at least until 1985. Currently, there are 500 companies earning close to $1 billion a year in tax-free profits in Puerto Rico.16/ Similar liabilities undoubtedly exist for earlier years and for other taxpayers which were not assessed. All indications point to protracted litigation over these liabilities or settlement of the asserted deficiencies for nominal amounts. The unitary method as applied by the states solves this problem quickly and cleanly.

A note in the Harvard Law Review in April of 1976 concluded:

> The use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the surprisingly (sic) frequent reliance of revenue agents and courts on ad hoc fourth method approaches, based not on the theory of the regulation, but on the unitary entity theory. While the unitary entity theory itself is not free from difficulty, it has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to current practice.17/

The reason the arm's-length standard must fail was set forth in a recent study of Section 482 which was reported in the Journal of Taxation:

> Section 482 is based on the premise that a subsidiary is legally and economically separate from its parent corporation. In contrast, only 41% of the participants state their organizations actually operate in this manner. Although composed of numerous legally separate entities, 49% of the participants reveal that their companies make most intercompany pricing decisions as though the organization is one economic unit. This basic difference in philosophy between the IRS and multinational corporations is central to the Section 482 controversy. Without this fundamental difference, many tax problems involving intercompany transfer pricing would disappear.18/

Tax administrators are not the only ones who question the validity of results obtained in a separate accounting analysis. In the fall of 1973 the Harvard Business Review carried an article entitled "The Bent Measuring Stick for Foreign Subsidiaries." While the article was addressed principally to the problems of management evaluation, it nonetheless makes a case for the use of the unitary method. According to the authors, costs or benefits which are difficult to value include the following items, among others:

> [M]anagements establish and operate their overseas ventures as strategic systems. (p. 81)
>
> [A] subsidiary that purchases many components from other units in the system might make a greater contribution, but report a lower profit, than a subsidiary that does not purchase many components within the system. (p. 86)
>
> [A] parent's guarantee of a loan for a subsidiary. There is likely to be a substantial difference between the cost of the guarantee to the parent and the worth of it to the subsidiary. (p. 81)
>
> [A] safety inventory intended to serve several foreign operations in addition to the U.S. operations. The cost of this extra safety stock is less for the foreign subsidiaries than if each were required to hold its own. (p. 81)

> [A] company introduces all its new products in the United States. Only those products that succeed and are deemed likely to succeed also in Europe and then introduced there. The company makes no attempt to capture the cost of such screening in the United States by adjusting upward the technical fees charged by the parent to European operations. Yet records show, and it is widely believed in the company, that European operations are more profitable than U.S. operations. (p. 84)
>
> In most cases, the incremental costs to a parent of providing services for a subsidiary usually are quite low; but the value to a subsidiary can be substantial. Since a free market seldom exists for such services, it is difficult to determine actual value, and this fact complicates any attempt to measure profits. (p. 84)
>
> Then there are the intangible items, such as the strategic considerations discussed earlier, whose worth or cost is even more elusive; to date they have universally been omitted from the initial formal calculations. For example, no manager of a major oil company would want to risk being left out of a potentially giant oil field that one of his company's rivals is exploring, even if the calculations of expected costs and returns might show a loss when discounted cash flow procedures are used. The risk of a rival finding a huge, low-cost oil field, and thereby gaining a superior long-run competitive position, is too big for the manager to take. (p. 81)
>
> Presumably, management could determine the true economic benefits of the subsidiary by comparing the entire corporate system with and without the subsidiary in question. But such an exercise would be hopelessly complex if done on a regular basis for a number of subsidiaries. (p. 85)
>
> [T]o do so accurately, these statements must be adjusted to take into account the extent to which the subsidiary influences the profits of the other units in the system. Yet any enterprise attempting to make such adjustments encounters acute complexities. (p. 83) [19]

In short, the problems involved in separate accounting are virtually insolvable for corporate management itself and are far beyond the capabilities of the audit staffs of the states.

The proposed treatment of dividend income by Title III of S. 983 and by S. 1688 would serve no apparent purpose other than as a shield for the business community. Dividends are basically divided into three classes by Section 302 of S. 983. These classes are: (1) dividends from less than 50 percent owned companies paid out of income earned in the United States; (2) dividends from less than 50 percent owned companies paid out of income earned out of the United States; and (3) dividends from corporations in which the recipient owns 50 percent or more of the voting stock. Dividends in class 1 are allocated to the commercial domicile of the recipient. Dividends in classes 2 and 3 are not taxable by an state. S. 1688 establishes a complicated formula for excluding what is apparently considered to be so-called "foreign source" income.

The United States Supreme Court in Mobil, supra, considered the treatment of dividends paid by corporations operating in foreign lands. The court stated that:

> [T]he argument that the source [foreign] of the income precludes its taxability runs contrary to precedent . . . . The court has applied the same rationale to businesses both here and abroad.[20]

The court went on to:

> reject the suggestion that anything is to be gained by characterizing receipt of dividends as a separate 'taxable event' . . . . 'tags' of this kind 'are not instruments of adjudication but statements of result,' and that they add little to analysis. . . .
>
> * * *
>
> [T]he form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability . . . . Transforming the same income into dividends

> from legally separated entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.[21]

All dividends should be either specifically allocable to a single state, in most cases the state of commercial domicile, or included in apportionable income and, therefore, subject to taxation by all states. The only exception to this should occur when the dividends are paid out of income which has been included in the apportionable base. Apparently, this is the thrust of Title III with respect to the dividends which we have classified as class 3 dividends. However, Title III establishes numerous situations where a more than 50 percent owned corporation is not includible in a combined report or consolidated return. In these situations, there is no longer any valid rationale to exempt such dividends from state taxation. The fact that dividends are paid out of so-called "foreign source" income provides no basis for a tax exemption. Such income is just as much a result of the recipient's business activities as are its operating results. Both should be taxable by the states.

The question of whether dividends should be specifically allocated to a single state or apportionable among several states should not turn upon the percentage of stock owned but rather, as the court pointed out in Mobil, supra, upon the relationship of the stock ownership to the business activities of the owner. Furthermore, the establishment of an allocation *per se* rule is fundamentally unsound since it will result in the establishment of artificial commercial domiciles in those states which choose not to tax dividends.

Finally, Title III is sadly defective in that it does not provide for full accountability. That is, it provides for a free lunch for certain taxpayers. As has been said before, "there is no such thing as a free lunch." If large corporations do not pay their fair share of the tax burden, then small business and the individual must pick up the tab.

At the hearings which were held in San Francisco in 1978, certain members of the business and tax community professed unfamiliarity with and uncertainty as to the meaning of the concept of "full accountability."[22] To label their position as disingenuous is surely an understatement. But in order to ensure there is no misunderstanding, let it be clear that by "full accountability" we mean that all income should be either allocable or apportionable to some jurisdiction which under the laws of this country has a sufficient nexus to assert a tax. There is no requirement that a tax, in fact, be asserted, but merely that the power to assert one exists.

The most obvious example, but not the only one, where Title III of S. 983 provides for less than full accountability is in its failure to provide for a throwback rule in the sales factor.[23] Opponents of the throwback rule argue that its application puts an added burden on small businesses and is unimportant to big business. First, the throwback rule does not increase the compliance burden of small businesses. The rule is very simple. If a taxpayer is not taxable in a state where it has sales (Public Law 86-272 for example) the sale is thrown back to the home state.[24] No greater compliance cost is involved. Either the sale goes to the state where it is made or it goes to the home state. Second, an examination of the litigants in cases involving the throwback rule suggests that it is mainly big business who is concerned. (General Telephone & Electronics, Illinois; Covington Fabrics, South Carolina; Hoffman La-Roche, California; Adolph Coors, Colorado.)[25]

Elimination of both the throwback concept and full accountability will not benefit small businesses. To the contrary, the shield which they would offer to big business would only increase the burden of small businesses and individuals who must shoulder not only their fair share of the burden of government but also the fair share of multistate and multinational business which this bill would allow them to avoid.

As has been the case since restrictive federal legislation was first proposed, the states are convinced that despite what you will be told today, the major problem with respect to state income taxation of interstate and international corporations is not overreaching, but underreporting by such taxpayers. The concept of "full accountability" addresses this problem. Before accepting any of the assertions which will be made, we urge the Committee, as we have for many years, to subpoena the returns of a representative group of taxpayers and determine if, in fact, overreaching or underreporting is the norm.[26]

The means for such an inquiry are currently available. The General Accounting Office, at the request of the Committee on Ways and Means of the House of Representatives, is conducting studies of state tax procedures, including the unitary method and the arm's-length standard used by the Internal Revenue Service. It is the understanding of the Franchise Tax Board that this study was undertaken because questions have arisen as to the effectiveness of the arm's-length approach and what we perceive is the superiority of the unitary method. In conjunction with the study of state tax methods, the General Accounting Office should determine whether there is in fact any validity in corporate claims of multiple state tax burdens. Action by this Committee or by Congress on either S. 983 or S. 1688 prior to the completion of these studies by the General Accounting Office would be precipitious.

In conclusion, the income tax provisions of S. 983 and S. 1688 would administer a serious blow to state revenues and would eviserate the efforts of state tax administrators to ensure that all taxpayers are treated fairly and equitably and that all pay their fair share of the cost of the benefits they receive from state governments.

Both bills should be rejected by the committee.

FOOTNOTES

1. For California's position, see P. 402, et seq., and p. 778, et seq., Hearings Before the Committee on the Judiciary, United States Senate, 95th Congress, 1st and 2nd Sessions, Hearings on Interstate Taxation, S. 2173 (1977-78).

2. Section 303(b) was amended to prevent taxpayers from electing to include corporations which the states were not permitted to include.

Section 358(c) was added to provide that factor elements relating to so-called "foreign source" income would not be included in the denominators of the apportionment factors.

3. Section 7518(a) provides ". . . no State, or political subdivision thereof, may take into account, or include in income . . . ." No such prohibition is applicable to corporations.

4. Hearings Before the Committee on the Judiciary, United States Senate, 95th Congress, 1st and 2nd Sessions, Hearings on Interstate Taxation, S. 2173, p. 336 (1977-78).

5. Ibid., p. 338.

6. Ibid., p. 470.

7. Ibid., p. 344.

8. Hearings Before the Committee on Foreign Relations, United States Senate, 95th Congress, 1st Session, Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, p. 146 (1977).

9. "State Taxation of Interstate Business, Senate Bill 2173, 95th Congress, Position Paper," State of California, Franchise Tax Board, Attachment 4.

10. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 75 L. Ed. 879 (1931).

11. See note 8 supra, p. 495.

12. ASARCO v. Commissioner of Revenue, ___ Mt. ___, 567 P.2d 901 (1977); ASARCO v. Idaho State Tax Commission, 99 Id. 924, 592 P.2d 39 (1979); F. W. Woolworth v. Director of Taxes, 45 NJ 466, 213 Atl.2d 1 (1965); Mobil Oil v. Commissioner, 136 Vt. 545, 394 Atl.2d 1147, aff'd U.S. Supreme Court, March 19, 1980; Caterpillar Tractor Co. v. Lenckos, 77 Ill.App.3d 90, 395 N.E.2d 1167 (1979); Xerox v. Comptroller of Treasury, Maryland Tax Court, October 15, 1979, CCH 200-897, aff'd Maryland Supreme Court, April, 1980.

13. 394 Atl.2d 1147 (1978), aff'd U.S. Sup.Ct. 63 L. Ed.2d 510 (1980).

14. "Recommendations of the Task Force on Foreign Source Income," Committee on Ways and Means, U.S. House of Representatives, March 8, 1977, p. 28.

15. "The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals," Department of the Treasury 1978, pp. 286-87.

16. The Wall Street Journal, February 14, 1980, p. 4, col. 1; The Wall Street Journal, June 9, 1978, p. 35, col. 3; "Closing in on Puerto Rico's Tax Haven," Business Week, May 22, 1978, P. 154.

17. Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code, 89 HARV. L. REV. 1203 (1976), p. 1238.

18. Burns, Jane "IRS Application of Intercompany Pricing Rules of Section 482: A Survey," The Journal of Taxation, Vol. 52, P. 308 (1980).

19. Robbins and Stobaugh, "The Bent Measuring Stick for Foreign Subsidiaries," Harvard Business Review, Sept.-Oct. 1973, pp. 80-88.

20. See note 13 supra, p. 521.

21. Ibid., pp. 522-23.

22. See note 4 supra, p. 439.

23. Section 357(b)(1).

24. Uniform Division of Income for Tax Purposes Act, Section 16(b)(2).

25. GTE Automatic Electric, Inc. v. Allphin, 369 N.E.2d 841 (1977); Covington Fabrics v. South Carolina Tax Commission, 212 S.E.2d 574 (1975); Hoffman-LaRoche, Inc. v. Franchise Tax Board, 101 Cal.App.3d 691 (1980); Coors Porcelain Company v. State, 517 P.2d 838 (1974).

26. Eg., see note 1 supra, pp. 408-9.

ATTACHMENT 1

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

Executive Committee

Position Paper*

on the

INTERSTATE TAXATION OF BUSINESS

The Executive Committee of the National Association of Tax Administrators is opposed to federal restrictions on the states' taxing authority. However, if the Congress concludes that legislation on the interstate taxation of business should be enacted, state tax administrators urge it to adopt and follow the principles set forth below:

I. Income Taxes

A. General Requirements

1. Legislation should mandate a method for determining an income ceiling for state taxes on or measured by income, but should not preclude any state from utilizing any method for determining the income attributable to it so long as the ceiling is not exceeded.

2. Any legislation should include a phase-in period to allow the states to adjust existing state laws if necessary. The recommended period is six years to accommodate states with biennial legislatures and to allow the governors of the states sufficient time to develop a coordinated program to implement necessary changes.

3. Legislation should be limited to those particular industries where the standard three-factor formula is generally conceded to properly apportion income, including, but not limited to, mining, manufacturing, retail and wholesale trading.

4. Because of the unique character of the business of oil and gas extraction, it should not be subject to a ceiling limitation where a state finds that a particular method of accounting is necessary to properly reflect the activities of the business within its boundaries.

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* Adopted by the Executive Committee at a special meeting held on March 19, 1979, in Chicago, Illinois.

5. **Legislation should limit only the measure of taxation of the described businesses and should in no way limit the states' ability to tax corporations in other businesses.**

6. **Legislation should apply only to income taxes or taxes measured by income and should not apply to severance, gross receipts, capital, or other similar taxes.**

7. **The states should retain authority to determine the income of an individual corporation pursuant to a combined report or consolidated return which could include corporations and activities not otherwise affected by the act.**

8. **There should be no limitation on a state's ability to utilize the worldwide income and activities of a business in determining the income taxable in a given state.**

9. **Any legislation should be prospective in nature only.**

10. **The legislation should be formulated to ensure full accountability by corporate taxpayers and should not result in the allocation or apportionment of income to jurisdictions or geographic areas where the business is not taxable.**

11. **Nexus or taxability should be determined on the basis of U.S. standards, both constitutional and statutory, regardless of whether the activities are carried on within or without the U.S.**

12. **Any future proposed legislation should be subjected to full hearings before the House Committee on Ways and Means and the Senate Finance Committee.**

13. **Any legislation which is enacted should be self-executing and should not require any additional state agency for administration beyond existing state tax departments, nor should any existing or new federal agency be assigned any administrative authority now vesting in any state tax department.**

14. **Any appeal procedure provided for shall be through existing state administrative or judicial appeal systems.**

B. **For Purposes of Determining the Ceiling Limitation the Following Rules Should Apply:**

1. **Income**

   a. **The states should not be restricted in determining their own income base.**

b. Characterization of income, such as business or nonbusiness, should be determined under the laws of the individual states.

c. Business income should be apportioned by an equally weighted three-factor formula consisting of property, payroll, and sales which give rise to business income.

d. Nonbusiness income should be allocated, in the case of real and tangible property, to the location of such property and, in the case of intangible property, to the business situs of the property or the owner's commercial domicile.

2. Property Factor

a. Property should be valued for factor purposes at original cost.

b. Rented property should be capitalized and included in the property factor.

c. Only property which is used or available for use in the business should be included in the factor.

d. Intangible property should not be included in the factor.

e. Movable property should be allocated to the states on the basis of time or mileage, or such other factors as is determined by the individual states.

f. Property which is in transit should be assigned to its destination.

g. Intangible drilling costs are to be included in the property factor at a state's option regardless of whether such costs are capitalized or expensed.

h. Property values should be determined on the basis of a beginning/ending year average unless a state determines that an alternative basis should be used to properly reflect values.

3. Payroll Factor

a. Compensation should include wages, salaries, commissions, and any other form of remuneration paid or payable to employees for personal services.

b. Payroll should be assigned to a state based upon where the services are performed or where the employee's activities are controlled.

4. Sales Factor

a. Sales should be assigned on the basis of destination, except U.S. Government sales to NASA or the Department of Defense which should be assigned to the jurisdiction from which the product is shipped.

b. The sales factor should be limited to those receipts which arise from the taxpayer's business activities. Receipts derived from intangibles, even though constituting business income, will normally be excluded from the sales factor, as will receipts from the occasional sale of assets.

II. Sales and Use Taxes

A. No federal legislation affecting state corporate income taxation should be considered without inclusion of provisions which improve and clarify state sales and use tax jurisdiction.

B. If Congress desires to address this area, it should be directed to:

1. Codification of existing jurisdictional standards as reflected in court decisions such as General Trading and Scripto; and

2. Providing power to the states to tax out-of-state vendors which otherwise escape state and local sales and use taxes, thus protecting small local businesses from tax free competition. If it is found necessary to provide for geographic accounting, then it should be on the basis of one rate per state, applicable to out-of-state vendors not included in the jurisdiction of 1., above.

C. Any federal legislation dealing with sales and use tax should not restrict the states' right to determine the measure of the sales tax or the nature of transactions to be taxed. For example, legislation should not concern itself with whether or not transportation charges should be included in the measure of tax, nor should it dictate whether sales to certain entities are taxable.

ATTACHMENT 2

Revenue Impact of S. 2173
and
Selected Statistics as to the Incidence of the California Bank and Corporation Tax Law

Research and Statistics has examined the results of a special study by Corporation Audit of multinational corporations doing business in California. The objective was to recompute the State corporation income tax if S. 2173 had been law. Frequently data that is needed to recompute net income under a different set of conditions is not determinable from the tax return. Audit used only tax returns for which there were completed audits which was the primary source for developing the estimated tax benefit from S. 2173.

Oil and Gas Corporations

Five oil companies were included in the sample and 21 separate audit years were individually analyzed for the estimated tax change. The audit years affected were 1970 through 1975. The total tax change for these 21 years was nearly $73 million and the average annual benefit ranged from $600 thousand to over $10 million. The average annual benefit for these five oil corporations totaled $21.7 million and is representative for the 1972 income year.

These five corporations report 30.5 percent of the California net income reported by multinational oil and gas corporations doing business in California.

Oil and gas profits have increased very dramatically in recent years. The most recent year for which data are available is 1977. The 1977 California net income of multinational oil and gas corporations was 3.75 times as great as it was in 1972.

Based on the above, if S. 2173 had been effective in 1972, we estimate that multinational oil and gas corporations would have had $71 million less in California tax liabilities. Because of the dramatic growth in profits of such corporations, their 1977 tax liabilities would have been $265 million less.

Other Corporations

Twelve other corporations were included in the sample and 45 separate audits were available for analysis. The audit years affected were 1970 - 1975 and, as an average, are representative of the 1972 income year. The total tax change for these 45 separate years totaled $11.8 million, and the average effect for all 12 corporations for a single income year (1972) was $4.1 million. These 12 general corporations represent 3.6 percent of all State net income reported by non-oil and gas corporations who are doing business in California and are affected by S. 2173.

If S. 2173 had been in effect for 1972, the estimated total tax savings by these affected non-oil and gas corporations would have been nearly $115 million.

The 1977 income year profits for this group of corporations were less than double (1.96) the 1972 profits. This is far less dramatic growth than for the oil and gas industry but still projects to a $220 million loss of revenue to California for 1977.

Summary

If S. 2173 had been in effect for the 1977 income year, then California would have had an estimated $485 million less in bank and corporation income taxes assessed. The detail behind this estimate is tabulated in the table below:

	1972 Income Year			Growth	
Industry	Sampled Corporations (millions)	Sample Ratio	Total Estimate (millions)	Factor to 1977	Estimated 1977 Effect (millions)
Oil and Gas	$21.7	3.25	$ 70.5	375%	$265
Other	4.1	27.80	114.0	195%	220
Totals	$25.8		$184.5		$485

Note that the estimated $485 million effect for 1977 represents nearly 30 percent of the 1977 income year self-assessed tax base of $1,661 million.

IN THE

Supreme Court of Illinois

CATERPILLAR TRACTOR CO., **CATERPILLAR AMERICAS CO.,** **CATERPILLAR CREDIT CORP.,** **CATERPILLAR FINANCE CORP.,** **and CATERPILLAR MACHINERY CORP.,** *Plaintiffs-Appellants, Cross-Appellees,* *vs.* **ILLINOIS DEPARTMENT OF REVENUE, et al.,** *Defendants-Appellants, Cross-Appellees,* and **COCA-COLA COMPANY, et al.,** *Intervening Plaintiffs-Appellants.*	**On Appeal from the Appellate Court of Illinois, Third District.** **No. 79-104** **There Heard on Appeal from the Circuit Court of the Tenth Judicial Circuit, Peoria County, Illinois.** **Case No. 78 L 5615** **Honorable Stephen J. Covey, Presiding Judge.**

BRIEF OF AMICI CURIAE

POINTS AND AUTHORITIES

ROLE OF AMICI CURIAE

Fiorito v. *Jones,* 72 Ill. 2d 73 (1978).

American Fur Company v. *United States,* 27 U. S. (2 Pet.) 358 (1829).

United States v. *American Trucking Associations,* 310 U. S. 534 (1940).

Andrews v. *Foxworthy,* 71 Ill. 2d 13 (1978).

INTRODUCTION

Mobil Oil Corp. v. *Commissioner of Taxes,* 48 U. S. L. W. 4306 (March 19, 1980).

ARGUMENT

I.

COMBINED REPORTING IS REQUIRED TO FAIRLY APPORTION INCOME OF A UNITARY BUSINESS

A. Apportionment on Separate Basis Cannot Be Policed

Internal Revenue Code Section 482, 26 U. S. C. § 482.

Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices,* 42 J. Taxation 106 (1975).

B. Unitary Method Essential for Fair Allocation of Profits and Losses

Edison California Stores, Inc. v. *McColgan,* 183 P. 2d 16 (Cal. 1947).

Butler Brothers v. *McColgan,* 315 U. S. 501 (1942).

II.

COMBINED REPORTING APPROPRIATELY STRESSES SUBSTANCE OVER FORM

Edison California Stores, Inc. v. *McColgan*, 183 P. 2d 16 (Cal. 1947).

Coca-Cola Company v. *Department of Revenue*, 533 P. 2d 788 (Ore. 1974).

Montana Department of Revenue v. *American Smelting & Refining Company*, 567 P. 2d 901 (Mont. 1977).

Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Taxation 106 (1975).

Mobil Oil Corp. v. *Commissioner of Taxes*, 48 U. S. L. W. 4306 (March 19, 1980).

ROLE OF AMICI CURIAE

Amici Curiae* are corporations which typify commercial enterprises in a number of different sectors of the business community in the State of Illinois. Collectively, they engage in a broad spectrum of business activities including commercial banking, glass and plastic products manufacturing, oil refining, retailing, operating and franchising restaurants, chemical products manufacturing, and electronic home entertainment products manufacturing. Although the business activities of these corporations are diverse, Amici Curiae share a common interest in this case: they believe that the combined method of reporting should be required in the State of Illinois.

Plaintiffs (Caterpillar Tractor Co. and certain subsidiaries) and Defendant (the Illinois Department of Revenue) have exhaustively briefed the legal arguments which support use of the combined method of reporting under the Illinois Income Tax Act. Amici Curiae should not burden this Court with a restatement of the arguments already ably presented in the briefs of those parties. The duty of Amici Curiae as friends of the Court is to provide advice and make suggestions with respect to points which have significant bearing on the issue at hand. *See, Fiorito* v. *Jones,* 72 Ill. 2d 73, 96 (1978). Amici Curiae believe that policy considerations overwhelmingly support the position that combined reporting should be required in Illinois. It is these policy considerations that Amici Curiae will seek to develop in this brief.

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* Amici Curiae are Continental Illinois National Bank and Trust Company of Chicago, Anchor Hocking Corporation, Clark Oil & Refining Corporation, Marshall Field & Company, McDonald's Corporation, Nalco Chemical Company, The Northern Trust Company, The Richardson Company, and Zenith Radio Corporation.

The importance of policy as an aid to statutory construction has long been recognized by the United States Supreme Court. *See, e.g., American Fur Company* v. *United States,* 27 U. S. (2 Pet.) 358, 366 (1829); *United States* v. *American Trucking Associations,* 310 U. S. 534, 542-44 (1940). Furthermore, this Court has acknowledged that proper interpretation of a statute cannot be based solely on its language, but "must be grounded on the 'nature, objects and the consequences which would result from construing it one way or another.'" *Andrews* v. *Foxworthy,* 71 Ill. 2d 13, 21 (1978). If a statute leaves doubt concerning the intent of the legislature (although we do not believe it does in this case) a court should examine policy considerations and construe the statute in the way best calculated to achieve sound policy objectives.

Throughout this brief terminology is used which carries with it a specific meaning. The definition of such terms as "formulary apportionment", "combined or unitary method of apportionment", and "separate accounting" are important to an understanding of the arguments presented. Plaintiffs have done an admirable job of defining and providing the background for such terms in Appendix A of their brief and Amici Curiae refer the Court to that Appendix for definitional purposes.

INTRODUCTION

A state income tax can only reach the income of a multistate business which is properly apportionable to the state. Two methods have been developed to determine the part of the income of a multistate business which the state is entitled to tax. One method is commonly referred to as the "formulary" method and the other method is commonly referred to as the "separate accounting" method.

The question before this Court is not whether formulary apportionment or separate accounting is the preferred method for determining the amount of a corporation's business income which is attributable to Illinois. The Illinois statute clearly provides that formulary apportionment is preferred. The question, rather, is whether the formulary approach must be artificially restricted when a unitary business decides to operate its business via separately incorporated subsidiaries rather than unincorporated divisions.

The issue can be brought into sharp focus with a very simple example. Assume that one Illinois corporation manufactures a product and sells it through a division in Indiana, while another Illinois corporation manufactures a product and sells it through a subsidiary in Indiana. Formulary apportionment clearly is applied to the total Illinois-Indiana income of the Illinois corporation which sells in Indiana through a division. Should it not also apply to the total Illinois-Indiana income of the Illinois corporation which sells in Indiana through a subsidiary?

Thus, the relevant question is whether combined reporting can be used to enable the Department to treat a unitary business in a consistent manner without regard to the corporate form in which the unitary enterprise conducts its business. Intervenors confuse the issue by arguing that "the Department would include within the unitary group corporations from the far-flung corners of the earth." However, Intervenors fail to point out that the formulary method itself, not combined reporting, causes that result and that the Department already includes divisions "from the far-flung corners of the earth" if they are part of a unitary group within a single corporation. Intervenors' arguments are not relevant to the issue before this Court.

As stated by the United States Supreme Court in *Mobil Oil Corp.* v. *Commissioner of Taxes,* 48 U. S. L. W. 4306, 4309 (March 19, 1980), "the linchpin of apportionability in the field of state income taxation is the unitary business principle." Amici Curiae believe that the arbitrary fragmentation of a unitary business into separate corporate entities should not be permitted to circumvent the Illinois legislature's intent to tax the portion of a unitary business' income which is properly attributable to Illinois.

ARGUMENT

I.

COMBINED REPORTING IS REQUIRED TO FAIRLY APPORTION INCOME OF A UNITARY BUSINESS

Where a unitary business is conducted through a number of separate corporations, each corporation in the group will generally maintain separate accounting records. Opponents of the combined method of apportionment argue that the existence of such separate records solves the problem of allocating specific items of income and expense to different segments of the unitary business. They conclude that apportionment on a separate basis (corporation by corporation) is the appropriate method for dividing the income of a multicorporate enterprise among the states in which it operates.

There are at least two basic reasons why apportionment on a separate basis is unsound for a truly unitary business. First, apportionment on a separate basis would be extremely difficult, and often impossible, to administer fairly. Second, apportionment on a separate basis does not result in a fair distribution of profits and losses of individual members of a unitary business among all members of the group.

A. Apportionment on Separate Basis Cannot Be Policed

Any failure to maintain arm's-length dealings in transactions between members of a multicorporate unitary business will result in distortion of the income of the individual members. With combined reporting, the potential problem of distortion is eliminated by combining the income of each member of the unitary group prior to apportionment. If apportionment is made on a corporation by corporation basis, however, any distortion is preserved. Thus, if apportionment on a separate basis is permitted, the Department must closely police all transactions between members of the unitary group to insure that the transactions are conducted at arm's length.

If apportionment on a separate basis is permitted, some taxpayers may be tempted to manipulate prices in order to reduce tax liability in the taxing state. Although a taxpayer is entitled to structure its transactions to reduce its tax liability, it may not do so by arbitrarily assigning non-arm's-length prices to its goods or services. Without combined reporting, the Department might be forced to sort through thousands of transactions to determine the proper income of a single unitary business.

While the overwhelming majority of taxpayers make every effort to comply with the tax laws, it is often very difficult to determine proper pricing of intercorporate transactions and there will inevitably be many good faith disagreements between taxpayers and revenue collection agencies. Policing of transactions between related companies to insure that they are arm's-length is particularly difficult when there is a lack of competitive pricing information. In some instances, a product may be unique (*e.g.*, a manuscript, motion picture, or master recording) and information on property of a similar type may not be very helpful in determining an arm's-length price. In other instances, a product may be transferred at an interim stage in the manufacturing process when no similar sale would be made by unrelated parties, and thus no arm's-length price would be available. Thus, even after the non-arm's-length transactions are identified, the Department may still have difficulty in determining a proper arm's-length price.

The scope of the problem of policing transactions between related parties is shown by the myriad cases under Section 482 of the Internal Revenue Code, which allows the Internal Revenue Service to reallocate various items among separate corporations in order to clearly reflect the income of the corporations for Federal income tax purposes. One commentator has noted that such policing at the state level "would require an army of agents greater than the total number of agents employed by all the states and the Federal Government combined."*

Accordingly, permitting a unitary group of corporations to report income on a separate basis will create substantial administrative burdens for the Department and will prevent fair enforcement of the law. The Court should require combined reporting so that the Department will not be forced to rely on a hit-or-miss method of determining the amount of income attributable to Illinois.

B. Unitary Method Essential for Fair Allocation of Profits and Losses

Even if the state could determine that all transactions among members of a unitary group were conducted at arm's length, reporting the income of each corporation on a separate basis is still inappropriate for a unitary business. The cornerstone of unitary apportionment is the assumption that the various segments of a unitary business are interrelated and vital parts of the whole business. Even though a portion of a unitary business may only break even or even be unprofitable on a separate basis, it may contribute to the profitability of the larger enterprise in numerous ways which may not be recognized under any separate accounting system.

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* Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Taxation 106 (1975).

The courts of several states have recognized that a unitary business is inseparable even where segments of the business are separately incorporated. The Supreme Court of California concluded in the leading case of *Edison California Stores, Inc.* v. *McColgan,* 183 P. 2d 16 (Cal. 1947), that a California subsidiary corporation, engaged in selling merchandise, contributed to the profits of the whole unitary enterprise in the same way that a California branch contributed to the profits of the unitary business in *Butler Brothers* v. *McColgan,* 315 U. S. 501 (1942), *i.e.,* by enabling the enterprise to obtain more favorable prices on its purchases. Thus, the court applied combined formulary apportionment to the business despite a finding that the subsidiary corporation's separate accounts were reasonable and accurate.

Contributions to a unitary enterprise may even be less tangible: a member of the unitary group may be an excellent training ground for management personnel who later work for another member of the group; a member of the unitary group may serve a role in attaining a "national" status for the unitary enterprise.

The impossibility of identifying, let alone quantifying, the contributions of a segment of a unitary business to the enterprise as a whole makes reporting on a separate basis undesirable. Thus, combined reporting provides a better means of achieving the legislature's goal of an equitable method of apportionment.

II.

COMBINED REPORTING APPROPRIATELY STRESSES SUBSTANCE OVER FORM

Intervenors concede that formulary apportionment is proper under the Illinois Income Tax Act. However, they argue that where a unitary group member is a separate corporate entity, formulary apportionment should apply to that corporation separately. Amici Curiae contend that because of the interdependence of the entities which make up the unitary group combined reporting is essential to achieve a fair apportionment of income. This interdependence exists whether the unitary group is made up of corporate or noncorporate entities. Accordingly, formulary apportionment should apply on a combined basis.

The application of formulary apportionment to each corporate member of a unitary group on a separate basis would elevate form over substance. Assuming that the enterprise is unitary, its tax liability should be the same whether it is structured (i) as a single corporation consisting of separate divisions, or (ii) as a multicorporate enterprise in the form of a parent corporation with separate subsidiary corporations. In applying formulary apportionment Intervenors would distinguish (i) from (ii). In situation (i), they would combine the separate divisions of the single corporation and apportion the divisions' income as a unit. Yet in situation (ii), Intervenors would treat the parent corporation and each of its subsidiaries separately. They would apply formulary apportionment to the parent corporation on a separate basis and to each subsidiary corporation on a separate basis. The emphasis on structural form in Intervenors' argument is apparent.

The Illinois Income Tax Act should be interpreted so that the taxpayer's decision whether to operate his business as a corporation with divisions or a corporation with subsidiaries is made on the basis of economic and not tax considerations. Separate reporting might encourage some taxpayers to fracture their business into subsidiaries solely because of the advantage gained under the Illinois Income Tax Act.

The following example illustrates the consequences of ignoring the substance of the unitary enterprise and stressing its structural form.

EXAMPLE

Widget Corporation, Inc. is an Illinois corporation engaged in the manufacture and sale of widgets. Widget Corporation, Inc. has a separate unincorporated division, Western Widget Division, which conducts all sales operations for Widget Corporation, Inc. on the West Coast of the United States. Widget Corporation, Inc. also has a wholly-owned subsidiary corporation, Eastern Widget Subsidiary, which conducts all sales operations for its parent corporation on the East Coast of the United States.

The operations of Eastern Widget Subsidiary are identical to those of Western Widget Division. Neither Western Widget Division nor Eastern Widget Subsidiary manufactures widgets. Widget Corporation, Inc. manufactures all of the widgets which are sold by its division and corporate subsidiary. Widget Corporation, Inc. engages in no sales operations on its own. It is assumed that Widget Corporation, Inc., its division and its corporate subsidiary constitute a unitary business. Western Widget Division and Eastern Widget Subsidiary are completely dependent on Widget Corporation, Inc. for the widgets which they sell.

In a given year, Western Widget Division and Eastern Widget Subsidiary each earn income of $100,000 on sales. Widget Corporation, Inc. earns no income since it sells at cost. (It is recognized that Widget Corporation, Inc. probably should not sell at cost since it normally would be entitled to a manufacturing profit. However, see the discussion of administrative problems in I. A. of the argument at page 8 above). Western Widget Division and Eastern Widget Subsidiary each have property, payroll, and sales of $200,000, all of which is the result of sales operations outside Illinois. Widget Corporation, Inc. has $200,000 of property, payroll, and sales inside Illinois as a result of the location of its manufacturing facilities there. Table I summarizes the amounts set forth above.*

TABLE I—FACTS

	Income	Property Payroll Sales Inside Ill.	Property Payroll Sales Outside Ill.
Widget Corporation, Inc.		$200,000	
Western Widget Division	$100,000		$200,000
Eastern Widget Subsidiary	$100,000		$200,000

Under the combined method of reporting, formulary apportionment would apply to the income of the unitary group as presented in Table II.

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* The apportionment formula under the Illinois Income Tax Act is a three factor formula based on property, payroll and sales. For purposes of simplification, this example treats the factors in the aggregate.

TABLE II—Combined Reporting

Illinois
Property-Payroll-Sales
of
Widget Corporation, Inc.
Western Widget Division
Eastern Widget Subsidiary
——————————— X Income of
Widget Corporation, Inc.
Western Widget Division
Eastern Widget Subsidiary
Illinois and Non-Illinois
Property-Payroll-Sales
of
Widget Corporation, Inc.
Western Widget Division
Eastern Widget Subsidiary

$$\frac{\$200{,}000}{\$600{,}000} \times \$200{,}000 = \$66{,}667 \text{ subject to Illinois Income Tax}$$

Income of Unitary Group Subject to Illinois
Income Tax = $66,667.

Table III illustrates how formulary apportionment would apply to the unitary group on a separate basis.

TABLE III—Separate Reporting

(1) Application of Formulary Apportionment to Widget Corporation, Inc. and its unincorporated division, Western Widget Division.

$$\frac{\begin{array}{c}\text{Illinois}\\ \text{Property-Payroll-Sales}\\ \text{of}\\ \text{Widget Corporation, Inc.}\\ \text{Western Widget Division}\end{array}}{\begin{array}{c}\text{Illinois and Non-Illinois}\\ \text{Property-Payroll-Sales}\\ \text{of}\\ \text{Widget Corporation, Inc.}\\ \text{Western Widget Division}\end{array}} \times \begin{array}{l}\text{Income of}\\ \text{Widget Corporation, Inc.}\\ \text{Western Widget Division}\end{array}$$

$$\frac{\$200{,}000}{\$400{,}000} \times \$100{,}000 = \$50{,}000 \text{ subject to Illinois Income Tax}$$

(2) Application of Formulary Apportionment to Eastern Widget Subsidiary.

$$\frac{\begin{array}{c}\text{Illinois}\\ \text{Property-Payroll-Sales}\\ \text{of}\\ \text{Eastern Widget Subsidiary}\end{array}}{\begin{array}{c}\text{Illinois and Non-Illinois}\\ \text{Property-Payroll-Sales}\\ \text{of}\\ \text{Eastern Widget Subsidiary}\end{array}} \times \begin{array}{l}\text{Income of}\\ \text{Eastern Widget Subsidiary}\end{array}$$

$$\frac{\$0}{\$200{,}000} \times \$100{,}000 = \$0 \text{ subject to Illinois Income Tax}$$

Income of Unitary Group Subject to Illinois Income Tax = $50,000.

As Table III illustrates, apportionment of the income of the unitary group on a separate basis results in all of the income earned by Eastern Widget Subsidiary escaping apportionment under the Illinois Income Tax Act, even though the manufacturing facilities upon which this income depends are located within Illinois. On the other hand, all of the income earned by Western Widget Division is subject to the Illinois apportionment formula because it operates as a division of Widget Corporation, Inc. rather than as a subsidiary corporation. Hence, if the income of the unitary group is apportioned on a separate basis, Widget Corporation, Inc. will have benefited under the Illinois Income Tax Act simply by incorporating its East Coast sales operations into a separate corporation.

If the example were altered so that either (i) Widget Corporation, Inc. and Western Widget Division were located outside Illinois while Eastern Widget Subsidiary was located inside Illinois or (ii) Widget Corporation, Inc. was located outside Illinois while Western Widget Division and Eastern Widget Subsidiary were located inside Illinois, a greater Illinois tax liability would result under separate reporting than under the combined method.

The point of this example, however, is not to show that Illinois exacts a greater or lesser tax depending on which method is used. The respective parties would agree there is a difference. Amici Curiae merely wish to illustrate that, given the fact that formulary apportionment has been adopted in Illinois, basing the tax liability of a group of interdependent and inseparable business activities on whether a particular activity is structured as a separate corporation places a wholly unwarranted emphasis on the structural form of the enterprise.

Courts in other states have recognized that the structural form of the unitary enterprise should not affect the apportionment of income and, therefore, have required use of combined reporting. *See, Edison California Stores, Inc.* v. *McColgan*, 183 P. 2d 16, 21 (Cal. 1947); *Coca-Cola Company* v. *Department of Revenue*, 533 P. 2d 788, 792-94 (Ore. 1974); *Montana Department of Revenue* v. *American Smelting & Refining Company*, 567 P. 2d 901, 908-09 (Mont. 1977). Similar recognition has been accorded in legal commentary. Frank M. Keesling explains that the *purpose* of the combined report is to assure that where a business is conducted both inside and outside the taxing state, the business' income will be apportioned in the same fashion whether the business consists of one corporation or multiple corporations. He notes that in both cases the income of the business is computed as a unit, apportioned by applying the appropriate formula, and the amount so apportioned is added to any nonbusiness income which the taxpayer derives from sources within the taxing state. Thus, in determining the amount of business income attributable to a particular state, "no advantage is obtained, and no detriment suffered, as the result of employing a number of corporations rather than one to operate the business." Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Taxation 106 (1975).

Furthermore, the United States Supreme Court's recent opinion in *Mobil Oil Corp.* v. *Commissioner of Taxes*, 48 U. S. L. W. 4306 (March 19, 1980), reflects unwillingness to permit the structural form of a unitary enterprise to affect issues of taxation. In *Mobil Oil*, the taxpayer argued that the inclusion, by a non-domicillary state, of dividends received from the taxpayer's foreign subsidiaries and affiliates in the income tax base subject to apportionment violated the Due Process and Commerce Clauses of the United States Constitution. In the context of the taxpayer's due process challenge, the Court refused to draw any distinction on the grounds that the income was received in the form of dividends from separately incorporated entities rather than derived from intracorporate divisions.* The Court stated:

> "Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U. S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." 48 U. S. L. W. at 4310.

The purpose of formulary apportionment under the Illinois Income Tax Act is to fairly and equitably attribute the income earned by a unitary enterprise to the business activities which it conducts within the State. Amici Curiae submit that fairness and equity cannot be achieved if a distinction is made merely because a segment of the unitary enterprise operates as a separate corporation.

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* Amici Curiae acknowledge that the Court refused to decide whether the Due Process Clause requires combined reporting. 48 U. S. L. W. 4306, n. 15. However, Amici Curiae believe that the Court's distaste for arguments emphasizing form over substance bears noting.

CONCLUSION

In light of the foregoing policy considerations, Amici Curiae respectfully request that this Court affirm that portion of the decision of the Appellate Court which would require the combined method of reporting in the State of Illinois.

Respectfully submitted,

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ATTACHMENT 4

The President's 1978 Tax Program

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Detailed Descriptions and Supporting Analyses of the Proposals

January 30, 1978

DEPARTMENT OF THE TREASURY Washington, D.C.

TERMINATING DEFERRAL

Present Law

Under present law U. S. citizens, residents, and corporations are subject to U. S. taxation on their worldwide income. Foreign corporations, including foreign corporations controlled by U. S. taxpayers, are generally subject to U. S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U. S. shareholder is usually consolidated with the income of the U. S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U. S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U. S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U. S.-controlled foreign corporation until that income is distributed to the controlling U. S. shareholders. The term "deferral" is employed because the net U. S. tax liability -- equal to the difference between the U. S. tax and the credit for foreign taxes -- is "deferred" until such income is distributed as a dividend.

Deferral does not apply when the nature of the controlled foreign corporation and its income exhibit "tax haven" characteristics. Tax haven income (so-called "subpart F income") is taxed currently to U. S. shareholders regardless of whether they actually receive the income in the form of a dividend. Likewise, U. S. shareholders are taxed on their pro rata share of the retained earnings of a foreign personal holding company, and on the earnings of any controlled foreign corporation which are in effect repatriated to the United States through the purchase of certain U. S. property.

Since the practice of deferral permits the income of controlled foreign corporations to escape current U. S. taxation until that income is repatriated as a dividend, it is important that transfer prices for transactions between U. S. shareholders and their controlled foreign corporations be properly determined. It is also necessary to ensure that reorganizations involving controlled foreign corporations are not undertaken for the purpose of tax avoidance. The tax law presently contains complex provisions designed to carry out these purposes.

Reasons for Change

The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U. S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U. S. taxpayers now have to locate new investment overseas rather than in the United States.

Terminating deferral will permit the rationalization and simplification of U. S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporations and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U. S. taxpayers to avoid U. S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.

(1) Terminating Deferral Will Preclude Substantial Tax Benefits From Turning on the Choice of Corporate Structure

When losses or large foreign tax credits are desired for U. S. tax purposes, a U. S. taxpayer may obtain these benefits currently by operating overseas through a branch. When foreign income does not generate sufficient foreign tax credits to offset U. S. tax, a current U. S. tax may be avoided by interposing a foreign corporate entity. A U. S. taxpayer is thus permitted to choose, through the form of its overseas operations, between two very different sets of substantive U. S. tax rules.

There is no good reason for this state of affairs. A choice of tax rules should not be accorded simply because business operations are situated abroad rather than in the United States. Such operations, in the case of a controlled foreign corporation, are an integral part of the overall activity of the U. S.-based firm, and the profits from such operations should, for this reason alone, be subject to current taxation in the United States.

In 1969 Congress dealt with a similar situation involving the availability of the $25,000 surtax exemption for each entity in a group of related domestic corporations. Congress took the view that a commonly owned business enterprise should be entitled to only one such exemption, whether it was operated under a single corporate charter or multiple charters and regardless of any genuine business reason for having multiple charters. The issue in the case of deferral is essentially the same: even if fully justified by business considerations, the interposition of foreign corporate charters should not affect the substance of U. S. taxation.

This point is, in fact, already recognized by some provisions of the Internal Revenue Code dealing with foreign income. U. S.

corporations are allowed a foreign tax credit (the so-called "deemed paid" credit) for taxes paid by their foreign subsidiaries. This allowance, which in 1975 amounted to more than $3 billion, reflects a recognition that the existence of a foreign corporate charter should not determine tax substance.

(2) Terminating Deferral Will End a Present Tax Incentive To Invest Overseas

Deferral gives U. S. taxpayers a substantial incentive to invest overseas for purely tax reasons. This incentive arises from a combination of the absence of current U. S. tax on the retained earnings of controlled foreign corporations, and the presence of tax inducements in many foreign countries. These foreign inducements take the form of low tax rates, rapid depreciation, tax holidays, and other special tax advantages not available in the United States.

U. S. investors need not look very far for tax holidays, for such benefits are heavily marketed in the United States. One foreign country, for example, publishes a brochure urging American business to "Get in on the . . . bonanza!" The bonanza includes "tax holidays, unlimited remittance of profits, repatriation of capital, protection against risks and the assistance offered by a friendly government from application to the start of production." Another recent advertisement in a business publication has a banner headline: "Exceptional Return on Investment Continues ...." As the advertisement explains, "export profits . . . are completely free of tax until 1990. So a U. S. subsidiary . . . . grows faster, and at less cost to the U. S. parent. In spite of the fact that profits can be freely repatriated, U. S. companies ploughed back 65 percent of them and notched up an expansion of U. S. investment of 30 percent." With an exemption from foreign tax and a deferral of U. S. tax, it is easy to understand why profit margins in this country are abnormally high.

Tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U. S. capital where it will be most productive, whether in the United States or overseas. The elimination of deferral will advance this policy, since it will tend to ensure that foreign investment will be motivated by genuine economic factors.

(3) Ending Deferral Will Permit Simplification of the Rules Relating to Taxation of Foreign Income

The termination of deferral will permit the simplification of U. S. rules relating to the taxation of foreign income. Subpart F, the rules relating to foreign personal holding companies, the rules governing the foreign tax credit, and the rules regarding reorganizations of foreign corporations will all be affected.

The subpart F anti-tax haven provisions originated in a proposal submitted to Congress in 1961 by President Kennedy. The purpose of that proposal, and of the provisions of subpart F, was to prevent U. S. businesses from exploiting the multiplicity of foreign tax systems and tax treaties so as to reduce or eliminate both U. S. and foreign tax liabilities.

Subpart F as drafted was not, however, structured to eliminate international tax avoidance by U. S. firms. It is focused exclusively upon a narrow class of so-called "tax haven" income. And its provisions are so complex that only a relative handful of persons are capable of understanding all of their implications. Although subpart F has doubtless discouraged many companies from undertaking blatant tax haven operations, highly sophisticated means of circumventing both the specific subpart F rules and their general objectives are available. Moreover, the Internal Revenue Service does not have the resources to mount an effective administrative effort to combat such schemes.

Terminating deferral for all controlled foreign corporations, as this proposal recommends, will permit the replacement of subpart F with a simpler, more comprehensible set of rules for U. S. taxation of foreign income. Terminating deferral will also permit repeal of the Internal Revenue Code provisions relating to taxation of foreign personal holding companies -- another series of provisions aimed at tax haven abuses.

Furthermore, terminating deferral will reduce the importance of the complicated rules relating to both the "deemed paid" foreign tax credit and multinational corporate reorganizations. The rules relating to the credit are not limited to controlled foreign corporations, and will have to remain in effect to cover foreign corporations owned in part, but not controlled, by U. S. persons. They will not, however, generally be required with respect to controlled foreign corporations if deferral is terminated, because a foreign tax credit will be available without regard to the "deemed paid" credit. The rules regarding corporate reorganizations will become less important because the potential for tax avoidance on the transfer of assets abroad will be diminished.

Eliminating deferral will thus have the highly desirable effect of making the U. S. system of taxing foreign income more comprehensible. The present system, complex and internally inconsistent, understood in all its detail by only a very few highly trained individuals, is simply not appropriate in the U. S. tax system. The rationalization of U. S. rules in this area will permit the Administration and Congress to see more clearly where real problems exist and to structure appropriate solutions having no unintended and unforeseen consequences for either taxpayers or the government.

(4) Terminating Deferral Will Help Equity and Competition

The present system of U. S. taxation of foreign income, with deferral as its centerpiece, has produced increasingly sophisticated methods of tax planning by those involved in multinational transactions. As the Internal Revenue Service has issued new Regulations limiting opportunities for tax avoidance, and as Congress has tightened various rules in the system, taxpayers have become more and more ingenious in avoiding their impact. Offshore financial subsidiaries, holding companies, and captive insurance affiliates have proliferated. Computer programs to guide tax planning efforts have been developed. The major accounting and law firms have devised ever more refined planning techniques.

For example, the "rhythm method" of distributing dividends from foreign companies has become increasingly popular. Under this method foreign corporations only pay dividends to their U. S. parent companies in those years in which their effective foreign tax rate is high, rather than paying smaller dividends on an annual basis. Because of deferral and the "deemed paid" credit for foreign taxes paid by the foreign corporation, U. S. companies are able through this method to minimize U. S. tax on repatriated earnings. The technique illustrates how the existence of contradictory principles for taxing foreign income -- the "deemed paid" foreign tax credit which effectively treats parent and subsidiary as one enterprise, while deferral treats them as separate -- inevitably gives rise to opportunities for tax avoidance.

(5) Terminating Deferral Will Help Stop Practices Used To Avoid U. S. Tax

U. S. taxpayers have many opportunities today to avoid U. S. tax by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations, or imports the same from them. It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States.

In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. To determine whether the assigned transfer prices are appropriate for tax purposes, the United States and many other countries apply an arm's-length standard -- i.e., they require terms that would have been fixed in comparable transactions between an independent buyer and seller. The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.

Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.

Since the elimination of deferral will subject U. S. shareholders to current tax on the income of controlled foreign corporations, it may be expected to reduce if not eliminate the incentive to use techniques which serve to transfer excessive income to foreign corporations.

General Explanation

This proposal will phase out deferral over a three-year period. Beginning in 1981 the income of a controlled foreign corporation will be taxable as if it had been earned directly by the U. S. shareholder. This is the rule that has always obtained under the U. S. tax system where foreign operations are conducted by a U. S. taxpayer through a branch, rather than through a foreign corporation. Thus, U. S. tax liability under the proposal will closely approximate the amount that a U. S. shareholder would incur if it operated through a foreign branch. For 1979 and 1980 the above rule will apply to one-third and two-thirds, respectively, of the controlled foreign corporation's income.

The approach taken in this proposal will result in an accurate assessment of the U. S. shareholder's U. S. tax liability. Losses incurred by a controlled foreign corporation will be allowed to offset the U. S. source income of the shareholder. Similarly, foreign taxes imposed on the controlled foreign corporation will be treated as if they had been imposed on the U. S. shareholder and thus will be taken into account currently for purposes of the foreign tax credit rather than when the underlying income is actually repatriated.

The proposal allows the Treasury to consider the negotiation of tax treaties providing, in appropriate situations, that U. S. shareholders will not be taxed currently on certain income of their controlled foreign corporations operating in a treaty country.

Analysis of Impact

(1) Effect on Investment

Investment which is responding to real market forces will not be affected by the termination of deferral. Such investment represents a significant part -- but not all -- of U. S. overseas investment.

Most developed countries impose, in addition to corporate income taxes, withholding taxes on dividends, interest, and royalties paid to U. S. investors. Although the total tax burden in such countries is comparable to or higher than that in the United States, U. S. investment still flows to these countries because their markets are large and growing, consumer incomes are high, the demand for U. S. products is substantial, and a U. S. company can maintain its market position only by investing locally. Likewise, petroleum and other natural resource investments flow to countries with abundant natural resource deposits despite substantial tax and other payments to the governments in those countries. Finally, many less-developed countries attract labor-intensive production with low wage rates rather than tax incentives. These investments are far more typical of U. S. investment abroad than those motivated solely by tax considerations, and they will continue without the added benefits of deferral. Terminating deferral will thus operate to restrict only tax-induced investments.

The United States does not have any general interest in encouraging tax-induced investments. Foreign countries that offer tax incentives are not usually interested only in the type of investment that attracts exports from the United States and thus promotes domestic employment. To the contrary, foreign tax incentives are frequently aimed at the type of investment that promotes exports to the United States and thus displaces U. S. jobs. The United States has no reason to favor the latter category of investments.

There is good reason to believe that eliminating deferral will provide a moderate stimulus to total U. S. investment and employment. For some companies production in the United States is a direct and viable alternative to producing abroad. Some U. S. companies may have been induced by the combination of deferral and foreign tax incentives to stop exporting and start producing overseas. Alternatively, some companies may have stopped supplying the domestic U. S. market with goods made in the United States, electing instead to rely on imports from their own foreign affiliates. Moreover, even when domestic investment is not a direct substitute for foreign investment, domestic production can still benefit indirectly from the repeal of deferral. The capital that would have been used to finance a tax-induced foreign investment can be retained in the United States and used to finance an unrelated, but job-producing, domestic investment. The gains may be substantial in specific industries where foreign tax practices have hastened the export of jobs and capital.

(2) Competitiveness of U. S. Corporations Overseas

Some U. S. companies maintain that they cannot remain competitive in world markets without deferral. Any change which alters corporate tax burdens tends to alter the funds available for new investment, new research and development, and other programs aimed at expansion. But if this is true of deferral, it is equally true of other tax measures such as changes in the corporate tax rate or the investment tax credit.

These other methods of promoting competitiveness are better and fairer than deferral. In order to benefit from deferral, a corporation must invest abroad, not in the United States. As noted above, deferral may encourage companies to invest abroad for export back to the United States/ thereby undermining the competitiveness of U. S. companies that choose to stay at home. Zenith Corporation, for example, was forced to go overseas not only by its Japanese competitors (Sony, Panasonic, etc.) but also by its American rivals (RCA, Motorola, etc.) that went abroad to carry out assembly operations. Finally, deferral promotes continued investment overseas; repatriation of profits, which would help domestic investment, is actually discouraged by deferral. None of these perverse side effects of deferral characterizes reduction of the corporate tax rate and expansion of the investment tax credit, measures which the Administration has proposed.

It should be noted, finally, that the competitiveness of a corporation depends on its overall tax burden, not on any single tax provision. Terminating deferral represents only a small offset to the benefits envisioned for companies in the Administration's tax package.

(3) Reactions of Foreign Governments

It is often argued that if the United States terminates deferral, foreign countries will retaliate by discriminating against U. S. investors so that U. S. companies will pay higher taxes to foreign governments rather than the United States. Foreign countries, it is said, may revoke the eligibility of U. S. subsidiaries for tax holidays or accelerated depreciation, or they may deem all earnings distributed and thereby subject to high withholding taxes.

Such developments are, however, unlikely in the case of developed countries. The tax rates in most of these countries match those of the United States. Furthermore, most developed countries have tax treaties with the United States that require nondiscriminatory treatment of U. S. investors. Since residents of developed countries often have substantial investments in the United States, it is doubtful that these countries would risk abrogation of their treaties with the United States.

The United States has tax treaties with only a few less-developed countries, and the tax burden in some of these countries is lower than that in the United States. However, in many cases there will be no reason for these countries to retaliate against U. S. investment, because the termination of deferral will not produce higher U. S. taxes for many of the multinational companies operating within their borders.

Numerous U. S. companies already have an overall excess of foreign tax credits, and more will fall into this category if the U. S. corporate tax rate is reduced to 44 percent, as the Administration proposes. Under the "overall" foreign tax credit limitation -- the only limitation now in effect -- operations in low and high tax countries are combined. In the case of taxpayers with excess foreign tax credits, the United States will not, upon the elimination of deferral, impose any tax on profits from low-tax countries which are "sheltered" by excess credits from high-tax countries. Thus, many U. S. companies operating in foreign countries with a low rate of tax will not bear any more U. S. tax upon the elimination of deferral, and therefore those foreign countries will not have an incentive to raise taxes in retaliation to this proposal.

Furthermore, it is by no means clear that even a low-tax country believing that the end of deferral will subject U. S. investors to a higher U. S. tax burden will choose to retaliate. In the first place, it will be made clear that discriminatory taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States are not creditable under U. S. law. Low-tax countries desirous of promoting U. S. investments may not wish to take actions that could have the effect of actually penalizing such investments. More likely, such countries may wish to "validate" some of the tax incentives that they offer by seeking treaty provisions under which U. S. investors within their borders would continue to be entitled to deferral.

In some cases the United States may wish to validate the tax incentives that a developing country offers to U. S. investors. For example, investments that promote genuine economic development, have a minimal impact on U. S. employment, or increase U. S. access to critical raw materials may serve the national interest. But rather than giving a blanket incentive to foreign investment of all types and in all countries, the United States should focus the benefits of deferral through its tax treaty program. If deferral is terminated subject to exceptions by tax treaties, less-developed countries will be far more eager to conclude treaties with the United States than they have been in the past and developed countries that have treaties with the United States or are engaged in treaty discussions may be persuaded to offer favorable concessions.

(4) Administrative Impact Upon Taxpayers

It is sometimes argued that terminating deferral will involve serious administrative problems for U. S. companies. U. S. taxpayers, it is said, will not be able to maintain or obtain adequate records reflecting the income and deductions of controlled foreign corporations, particularly when there is no majority U. S. shareholder. It is also argued that the difficulty of translating books and records kept in foreign currency and under foreign standards into U. S. currency and standards justifies the retention of deferral.

The Administration is aware that there may be some administrative difficulties in some situations. However, U. S. companies with overseas branches, which have always been required to report foreign operations currently, have been able to solve these problems. U. S. parent corporations have long reported the earnings of controlled foreign corporations for SEC and general accounting purposes. And since 1962, controlled foreign corporations of U. S. shareholders have translated their books and records into U. S. standards for the purposes of subpart F. Finally, the provisions allowing for a "deemed paid" foreign tax credit, which have been in the law since 1918, require every U. S. corporation owning 10 percent of any foreign corporation (whether or not controlled by U. S. interests) to translate foreign books and records into U. S. standards in order to obtain the benefit of the indirect foreign tax credit. Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

Effective Date

The phase-out of deferral will apply to the first taxable year of each controlled foreign corporation ending in 1979 and to taxable years of U. S. shareholders with which or within which such taxable years of such foreign corporations end.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years

1978	1979	1980	1981	1982	1983
0	88	280	768	830	897

These estimates do not take into account the effect of the proposed reductions in the corporate tax rate. The revenue gain from terminating deferral depends on the spread between the U.S. and average foreign tax rates. Therefore even a relatively small decrease in the U.S. tax rate can substantially reduce the revenue gain from terminating deferral.

Behavioral adjustments could also affect these estimates. Some investors may, for example, increase their actual dividends and thereby incur foreign dividend withholding taxes; this would reduce net taxes paid to the United States.

Other behavioral adjustments could, however, increase U. S. tax revenues beyond the above estimates. U. S. investors may invest more at home and less abroad than they would if deferral were maintained. The reduction of tax incentives to manipulate intrafirm transfer prices in order to shift taxable income away from the United States could produce substantial revenues not taken into account in the estimates. Although the potential revenue gains from these location-of-investment and transfer-pricing adjustments are impossible to estimate, they could easily outweigh any adverse revenue consequences of other behavioral adjustments attributable to the elimination of deferral.

Technical Explanation

(1) **Current Inclusion of Income Earned by Controlled Foreign Corporations**

The proposal will currently include in the income of U. S. shareholders their pro-rata share of the gross income and deductions of controlled foreign corporations. Income and deductions of each controlled foreign corporation will be treated as having been earned and incurred by the U. S. shareholder. The character of the income or deduction will be the same in the hands of the U. S. shareholder as it would have been if the activity had been carried out abroad directly rather than through a foreign corporation. Controlled foreign corporations will, however, continue to be treated as corporations for the purposes of rules affecting transfer prices, corporate reorganizations, and other provisions of current law.

(2) Controlled Foreign Corporation

A controlled foreign corporation will be any foreign corporation of which either: (a) more than 50 percent of the total combined voting power of all classes of stock is owned, or is considered owned, by U. S. shareholders; or (b) more than 50 percent in the value of the outstanding stock is owned, or is considered owned, by U. S. shareholders. The use of a voting power test is consistent with present subpart F provisions. The use of a value test is consistent with the foreign personal holding company provisions.

(3) U. S. Shareholder

A U. S. shareholder is a U. S. person who owns, or is considered as owning, either: (a) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation; or (b) 10 percent or more in the value of the outstanding stock of a foreign corporation. For purposes of determining whether a company is a controlled foreign corporation and whether a person is a U. S. shareholder, the meaning of "U. S. person" as well as the constructive stock ownership rules will be substantially the same as those now contained in subpart F.

(4) Percentage Inclusion

The amount of a controlled foreign corporation's gross income and deductions attributable to a U. S. shareholder will be determined in proportion to that shareholder's rights to the net earnings of the corporation. This approach is substantially the same as that set forth in the current Regulations under section 1248.

(5) Treatment of Noncorporate Shareholders

Noncorporate shareholders required to include income and deductions currently will be treated as though such amounts were initially received by a domestic corporation. This rule, the mechanics of which have been developed under subpart F, will ensure equality of treatment between noncorporate and corporate shareholders.

(6) Losses

The excess of deductions over the gross income of a controlled foreign corporation will be treated as if realized directly by a U. S. shareholder, regardless of whether a corporate shareholder meets the stock ownership requirements for filing a consolidated return domestically.

If a U. S. shareholder has an overall foreign source loss attributable in whole or in part to the shareholder's pro-rata share of the losses of one or more controlled foreign corporations, the loss may offset his U. S. source income but will be subject to the recapture rules currently in section 904.

(7) U. S. Branch Rule

Gross income, deductions, and U. S. taxes of a U. S. branch of a controlled foreign corporation will be attributed to the U. S. shareholders of that corporation. This income will not, accordingly, be twice subjected to U. S. tax.

(8) Blocked Income

For the purpose of exchange control, certain foreign countries do not allow the expatriation of earnings derived within their borders. The proposal recognizes that it is inappropriate to tax currently all the earnings of a controlled foreign corporation in cases where distributions to U. S. shareholders have been "blocked" by currency or other restrictions imposed by a foreign country.

The Administration recognizes that the current rules with respect to blocked income may not be appropriate when deferral is terminated. It is anticipated that Regulations will be promulgated to describe those situations that prevailed prior to 1978 that will be treated as creating blocked income. However, any currency or other restrictions that are imposed solely against U. S. shareholders or imposed solely on a shareholder-by-shareholder basis will not be recognized as blocking income.

(9) Repatriation of Previously Taxed Income

Previously taxed income will be excluded from gross income of a U. S. shareholder when such income is distributed to the shareholder or any other U. S. person who acquires any portion of the U. S. shareholder's interest in the controlled foreign corporation.

(10) Basis Adjustments

As gross income and deductions of a controlled foreign corporation are recognized by the U. S. shareholder, an adjustment will be made to the basis of the shareholder's stock in the controlled foreign corporation. Actual distributions from the corporation that are excluded from gross income because they are attributable to previously taxed income will decrease such basis.

(11) Foreign Tax Credit

Since income and deductions will be treated as if realized directly by U. S. shareholders, foreign taxes paid by controlled foreign corporations, regardless of tier, will be treated as if paid directly by U. S. shareholders. This rule simplifies the foreign tax credit by making unnecessary the "deemed paid" foreign tax credit calculation in the case of U. S. shareholders of controlled foreign corporations. Further, the rule removes an inequity in current law, under which a foreign tax credit is denied for any year in which a foreign corporation has a deficit calculated under U. S. principles, even though taxes were paid to a foreign country.

Eliminating deferral reduces both a corporation's ability to control the effective rate of foreign tax by controlling the source and rate of dividend distributions and the corporation's ability to minimize timing differences in deductions between the United States and foreign countries. To allow for such timing differences, it is proposed that the foreign tax credit carryback be lengthened from 2 to 3 years and that the foreign tax credit carryforward be lengthened from 5 to 7 years. It will be made clear that a foreign tax credit will not be allowed for withholding taxes applied only to U. S. investors, or on a shareholder-by-shareholder basis, or to deemed distributions.

(12) Exchange Gains and Losses

The proposal provides that unrealized exchange gains and losses will be taken into account by a U. S. shareholder. This is the rule for financial accounting purposes and it is similar to a tax rule available to U. S. branches overseas and to the rule used to determine earnings and profits under subpart F. The proposal provides, however, that a U. S. shareholder may elect, with respect to all of its foreign operations, not to take into account unrealized exchange gains and losses. This election is revocable, on a prospective basis, ten years after it has been made.

(13) Accounting, Record Keeping, and Reporting Requirements

Rules will be provided for making elections with respect to controlled foreign corporations, translating amounts from foreign currency, the computation of taxable income and earnings and profits, the keeping of records and accounts, and the reporting requirements of U. S. shareholders.

In general, taxable income and earnings and profits will be computed under U. S. standards. The Administration recognizes, however, that there are differences between U. S. and foreign standards, and will prescribe Regulations describing the extent to which deviations from U. S. standards will be allowed.

(14) Tax Treaties

The proposal allows the Treasury to consider the negotiation of income tax treaties allowing deferral to continue, in appropriate situations, in treaty countries.

(15) Corporations Organized in Puerto Rico and U. S. Possessions

A current provision of subpart F allows a controlled foreign corporation organized in Puerto Rico or a possession of the United States to be excluded from subpart F if it meets certain tests with regard to the source and nature of its income and business. This provision parallels slightly broader statutory protection from U. S. tax granted by way of a special "possessions" tax credit available to electing domestic corporations doing business in Puerto Rico and the possessions (except the Virgin Islands).

This proposal allows U. S. shareholders to continue deferral with respect to income of corporations organized under the laws of the Commonwealth of Puerto Rico or a possession of the United States (including the Virgin Islands). Income that would have been eligible for the possessions tax credit currently provided by the Internal Revenue Code if the controlled foreign corporation had been a domestic corporation will not be taxed currently to U. S. shareholders. Instead, such income will be treated in the same manner as "blocked income."

(16) Transition Provisions

In 1979 and 1980, U. S. shareholders will be required to take into income 1/3 and 2/3, respectively, of the gross income and deductions of controlled foreign corporations. The provisions of subpart F will also apply during these two years, although most of subpart F will be repealed for years after 1980. The 1/3 and 2/3 inclusion in 1979 and 1980 will apply to the income and deductions of a controlled foreign corporation after adjustment for amounts included in income by a U. S. shareholder under the subpart F provisions. Thus, if in 1979 a U. S. shareholder's controlled foreign corporation has $150 of taxable income of which $30 is foreign base company income under subpart F, the inclusion under this proposal for the U. S. shareholder will be $40 (1/3 x ($150 - $30) = $40) and the U. S. shareholder's total taxable income attributable to the controlled foreign corporation will be $70.

The rules of subpart F will apply for purposes of calculating the foreign tax credit attributable to income included under subpart F, and the rules under this proposal will apply for purposes of calculating the foreign tax credit attributable to the additional amounts included in the U. S. shareholder's income under the proposal.

(17) Other Provisions

Various provisions of the Internal Revenue Code are modified or repealed under this proposal. The foreign personal holding company provisions are repealed after 1980. Subpart F is repealed for future operations, although it will be necessary to maintain certain historical aspects. For example, the rules relating to taxation of investments in U. S. property will continue to apply to previously accumulated earnings. Also, it will be necessary to determine whether actual distributions had been previously taxed under subpart F, and to determine the tax on certain amounts previously excluded from a U. S. shareholder's gross income under subpart F because they were reinvested in qualified shipping assets or in less-developed countries; any amounts thus excluded will be taxable when they are withdrawn from such investment. Section 1248 is also kept in force to handle accumulated earnings.

S-983 and S-1688

Statement of Kenneth Cory
Controller and Chairman of the Franchise Tax Board, State of California

Thank you for the opportunity to testify before this Committee. I am Kenneth Cory, the elected Controller for the State of California and Chairman of the California State Franchise Tax Board which administers California's income tax laws. I must object to S-1688 and S-983, each of which would hamstring the states' use of the unitary method of tax accounting. These bills represent another unwarranted intrusion into states' rights by multinational corporations who are shedding crocodile tears over alleged burdens. The opponents of the unitary tax have not produced a shred of evidence of inequity or inefficiency in the operation of the unitary method because they cannot -- there is no such evidence.

All states asserting an income tax employ the unitary approach. Passage of these bills would work to the detriment of these states and their citizens. The popular interest in preserving the unitary method was amply demonstrated just last year by the successful grassroots effort to reserve Article 9 (4) of the United States/United Kingdom Treaty. The unitary method is important to the states because it is the only efficient and accurate method of tax calculation that the states can effectively utilize with their limited audit resources. The so-called "arm's-length" method is recognized by all as nearly impossible for the states to use. Without the unitary method, states would be forced to depend on the Internal Revenue Service for its tax computations. The Internal Revenue Service, however, is also unsuccessful in using the arm's-length standard, even with its vast resources. When adjustments are made under the guise of the arm's-length standard, the methodology most frequently used is the unitary approach.

Critics of the unitary method claim that it results in double taxation. However, these critics have never supplied any tangible examples of such a result. In a recent Supreme Court case, Mobil Oil v. Commissioner of Taxes of Vermont, the Court cited this lack of evidence in its decision upholding the constitutionality and propriety of the states' use of the unitary method. In fact, Justice Blackmun criticized the separate accounting method, saying that "while it purports to isolate portions of income received in various States, [it] may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." 48 U.S.L.W. 4306, at 4309. In an even more recent case, Exxon v. Wisconsin, 48 U.S.L.W. 4687, released June 10, 1980, the Supreme Court unanimously reiterated its criticism of the multinationals' unsubstantiated complaints about the unitary method, and upheld the states' use of the method as a valid and necessary exercise of their taxing powers.

These bills are not small business relief acts. Only multinational corporations (and large multistate corporations) have the opportunity to manipulate income so that it is not tagged to a specific state. Since small businesses are unable to manipulate income to achieve favorable tax results by transferring profits among various subsidiaries they would be placed at a competitive disadvantage by the elimination of the states' unitary method. In other words, the unitary method does not burden small business nor result in double taxation, but rather it allows the states to collect the same proportion of taxes from multinational corporations as they do from any other business. By our estimates, California stands to lose approximately $485 million a year if this legislation is passed. This $485 million does not represent excess taxes, but rather the justifiable tax revenue that results from the closing of loopholes through which the income of multinationals would otherwise slip.

Another claim made by opponents of the unitary method is that it discourages foreign investment. Again, they have produced no evidence. In fact, an observer of the economic scene can readily see that foreign investment has been steadily increasing, in spite of the prevailing use of the unitary method by the states. California, perhaps the foremost exponent of the unitary method, is, year after year, the leading state in attracting foreign investment.

Corporate taxpayers have also criticized the rigidity of the three-factor formula, especially in cases where there are fluctuations in currency values, or where the apparent disparity between wages and real estate values in different locations are significant. The California State Franchise Tax Board has attempted to meet the need for flexibility by establishing a procedure for hearing the requests for relief on an individual basis. Very few corporate taxpayers have taken advantage of this procedure by presenting their grievances. Surely the multinationals must be exaggerating the dangers of the unitary method if they have not experienced substantial enough difficulties in California to request this personalized review taxation, but rather it allows the states to collect the same proportion of taxes from multinational corporations as they do from any other business. By our estimates, California stands to lose approximately $485 million a year if this legislation is passed. This $485 million does not represent excess taxes, but rather the justifiable tax revenue that results from the closing of loopholes through which the income of multinationals would otherwise slip.

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Testimony of Jonathan Rowe,
Associate Director, Citizens for Tax Justice,
Before
The Senate Finance Committee
on S.983 and S.1688
which would
Restrict State Taxation of Multinational Corporations

June 24, 1980

SUMMARY OF POINTS

1. **These bills would virtually exempt multinational oil companies and other multinational corporations from the income taxes of many states.**
2. **Such an exemption would cost the states hundreds of millions of dollars and would force more of the tax burden onto working people, farmers and small businesses.**
3. **Many of the benefitted companies already are paying minimal rates of state income tax.**
4. **The bills would reward oil companies and manufacturers which produce abroad instead of in the US.**
5. **The bills would force the states to use an ineffective bureaucratic tax enforcement method which even the Federal government has not been able to use successfully and which often results in double taxation of corporate income.**

Mr. Chairman, Members of the Committee:

Our organization, Citizens for Tax Justice, represents the people who would pay more so that the corporations benefitted by these bills could pay less. We represent the people who would suffer from the perverse economic incentives these bills would establish

Let's get right down to what these mandatory state tax cut bills would do.

I Mandatory State Tax Exemption for Dividends from Foreign Investment

One major provision of both bills would bar the states from taxing any portion of the dividends which a multinational oil company or other multinational corporation received from its foreign investments. This ban would apply even if the so-called "foreign dividends" were really US profits which the company had juggled into overseas tax havens by accounting maneuvers.

The Federal government would continue to tax its portion of these dividends. Only the state tax base would be eroded. In fact, the Federal government's take would increase because the corporations would have less state tax to deduct.

A recent Supreme Court case gives us a rare glimpse at what this foreign investment tax handout would do in practice.

The case* involved Mobil and the State of Vermont. From 1970 to 1972, Mobil made $27 million dollars in sales in the State, on which Vermont levied an income tax of $76,000. This was hardly an unreasonable tax. The $76,000 came to roughly one one- hundredth on one-percent of the company's Federal taxable income for these years. It was .3% of the company's sales in the state.

TABLE 1 EXAMPLE OF LIKELY IMPACT OF S.983 and S.1688 ON ONE STATE
(VERMONT)

Company	Years	Sales in State	State Income Tax	Likely Tax Under S.983 or S.1688
MOBIL	1970-1972	$27,000,000	$76,000	$1,871.90

Source: Mobil v. Vermont 445 US___,(1980)

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*Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 US____,(1980) Mobil wasn't satisfied, however. It said Vermont was taxing "foreign income" because it included in the company's income a portion of the dividends Mobil received from its Saudi Arabian consortium, ARAMCO, and three foreign subsidiaries.

Mobil wanted to pay Vermont the grand total of $1,871.90 on the $27 million worth of oil products it sold in the state during these three years.

Mobil took this case all the way to the Supreme Court. The Justices listened to Mobil's lawyer make the arguments about the state taxing "foreign income" and said, in effect, "Nothing doing".

These bills, however, give Mobil exactly what it wanted. They would reduce Mobil's income tax bill in Vermont from peanuts to pin-points. Mobil's tax bill for those three years would have come to one-eighth of the current price of a single full page advertisement in the Washington Post.

The likely effect on revenues in other states, oil consuming states in particular, would be similar. Generally, oil companies arrange their accounting to show profits from their foreign operations and losses from marketing.* They do this to take advantage of Federal tax provisions such as the foreign tax credit and deferral of taxes on "foreign" income. Such accounting contrivances are one of the reasons that a Mobil reports minimal profits in a state like Vermont, but instead shows over three-quarters of its profits in the form of dividends from "foreign" affiliates such as ARAMCO.

TO TOTALLY EXEMPT THESE DIVIDENDS FROM STATE TAXES, AS THESE BILLS WOULD DO IN EFFECT, WOULD BE VIRTUALLY TO EXEMPT COMPANIES SUCH AS MOBIL FROM THE INCOME TAXES OF MANY STATES.

Do these companies need the largesse the present bills would bestow upon them? Table 2, next page, gives an answer.

This table shows seven major oil companies including Mobil, which paid a lower rate of state income tax in 1978 than the average person making $16,000 paid the year before.

Mobil, for example, paid 1.5% of its total profits in state income taxes, compared to the 1.8% the $16,000-per-year individual had to pay.

Mr. Chairman, if this committee cannot find more needy recipients of state tax relief than the beneficiaries of this bill, then Citizens for Tax Justice stands ready to help you in this endeavor.

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*The recent Supreme Court case of Exxon v. Wisconsin, #79-509, decided June 10, 1980, provides further evidence of these accounting contrivances. Exxon claimed that it lost around one million dollars a year selling gasoline in Wisconsin for the four years 1965-1968. In those four years, its total US profits were $1,275,000,000.

TABLE 2 STATE/LOCAL INCOME TAXES: EFFECTIVE RATES

Individuals:	State/Local Income Tax Rate (1977)
Gross Income $32,000	2.9%
16,000	1.8

Oil Companies:	State/Local Income Tax Rate (1978)
Phillips	1.6%
Shell	1.6
Texaco	1.5
Mobil	1.5
Exxon	1.5
Standard Indiana	0.7
Continental	0.6
	0.3

Sources: Advisory Commission on Intergovernmental Relations, and Tax Notes, August 27, 1979

The salad days of free-lunch state tax cuts are over. The recession is taking its toll, cutting into state revenues, while inflation drives up costs. Congress is cutting back on grants-in-aid. There isn't any more slack. Tax handouts for multinational corporations will be passed on to working people, farmers and small businesses in the form of higher taxes or service cuts.

Much more is at stake than taxes, however. Equally important, if not more so, are energy policy and jobs. This bill affects each of these problems perversely.

Consider energy policy. We are supposed to be encouraging oil production, energy production, in the US, to curb our reliance on foreign sources. These bills would tilt the tax system in the opposite direction. They favor foreign production. They discriminate in favor of the large multinational oil companies and put domestic independent producers at a tax disadvantage.

If an oil company found new oil in Louisiana and set up a subsidiary to produce that oil, the dividends this domestic subsidiary paid to the parent company would be taxable by the states.

On the other hand, if this same company decided to produce oil abroad, under this bill, the dividends from this overseas production would be exempt from state taxes.

Is this how we encourage domestic energy production?

In similar fashion, the bills would give a tax break to manufacturers that move their factories and jobs overseas. Is this how we tackle unemployment here in the US?

II Federal Restriction on State Corporate Tax Enforcement

The second major provision of these bills would cripple the states in dealing with their most vexing corporate tax-enforcement problem. This problem is how to apportion the income of a multinational corporation among the states and nations in which the company operates.

The problem is incredibly complex. The corporate taxpayers want to keep it that way. These bills would accomplish that aim for them.

Billions of dollars are at stake. California alone would lose over one-half billion dollars from these bills, and one half that amount would go to multinational oil companies. Many states are just beginning to realize how multinational accounting legerdemain has been skirting their enforcement efforts, and so the total impact of these bills is incalculable at present.

Advocates of these bills have been engaging in legislative semantics. The issue,they say,is whether the states should be stopped from reaching out their greedy hands and taxing a company's "foreign income". The very caption on S.1688 implies that it is a bill to curtail the ability of the states to tax "income from sources outside the United States."

In law school, they called such semantic tactics "putting the rabbit in the hat". If you believe that the states are taxing "foreign income" then the conclusion is obvious that they should be stopped from doing so.

But taxing "foreign income" is not the issue.

Let me repeat. THE ISSUE IS NOT WHETHER THE STATES SHOULD BE ABLE TO TAX "FOREIGN" INCOME.

That issue was decided almost two hundred years ago. The states cannot tax "foreign source" income. Not one bit of it. The US Constitution says they can't. The Supreme Court says they can't. I challenge the proponents of this bill to find a single sentence in the Exxon case, in the Mobil case, or in any other Supreme Court case, or any other case, which suggests that the states presently can tax "foreign source" income.

The only reason this legislation is before you today is that the courts have held not only that the states cannot tax "foreign" income, but also that the states in fact have not been doing so.

Then what is the real issue? It is whether the states will have the tools they need to distinguish foreign income, which they cannot tax, from domestic income, which they can tax.

Why is distinguishing US from foreign income such a problem? Can't tax officials just look at a company's books?

A company's books don't help much. Many arrange their accounting to make as much income as possible appear to have arisen abroad, preferably in foreign tax havens. Actual foreign income, and what a company chooses to call foreign income, can be two different things.

Then how can tax enforcement officials deal with this accounting mess? There are two basic approaches.

These approaches are called the "arms length" approach and the "unitary" approach. Multinational taxpayers generally favor the former and the IRS obliges this preference. Disinterested commentators and the states increasingly favor the latter.

This bill would impose upon the states, whether they want it or not, the preference of multinational taxpayers.

The arms length approach pretends that the 200-plus subsidiaries of a Mobil are independent businesses, separate mom-and-pop stores scattered throughout the globe. Under this approach, tax officials must work their way through the spaghetti bowl of transactions among these subsidiaries, second-guess the prices and terms, and so adjust the company's accounting to what it theoretically would have been if its parts were really independent corporations.

It is understandable why many corporate taxpayers prefer this method. It creates plenty of complexity, plenty of accounting underbrush in which they can bury their income.

It is understandable why many corporate tax lawyers prefer this method. It creates plenty of work for tax lawyers, rearranging a company's corporate structure and accounting procedures to keep a step ahead of the IRS and state tax administrators.

It is understandable why many bureaucrats prefer this method. Disentangling the spaghetti bowl of transactions means lots of work for them.

None of these, however, are reasons for the US Congress to enshrine the antiquated arms length method into national policy, nor to impose it upon the states. Instead, Congress should be asking the IRS why it persists in using this anachronism.

Consider the following:

- The IRS's own study* on 1973 found that the arms length method didn't work 40% of the time. In many of these cases, the IRS had to resort to variations of the unitary method.

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*US Treasury Department, "Summary of International Cases Involving Section 482 of the Internal Revenue Code", January 8, 1973.

- A recent study* published in the Journal of Taxation found that double taxation of corporate income resulted in 52% of the cases in which the IRS employed the arms length method.

- This same study found that 59% of the corporations studied admitted that they didn't treat their subsidiaries as separate independent businesses, even though the arms length method pretends that they do.

- Leading corporate managers publicly proclaim that they treat their foreign and US operations as part of a single, or "unitary" business:

> *David Rockefeller wrote in the Christian Science Monitor (March 20, 1980) that the task of the corporate executive is to "view his company's overseas and domestic interests as integrated parts of an overall management pattern."*

> *"For business purposes the boundaries that separate one nation from another are no more real than the equator", the President of the IBM World Trade Corporation told the authors of the book Global Reach.*

The alternative to the arms length method is the co-called "unitary" method. This method treats the multinational corporation as what David Rockefeller and other managers say it is, a unified entity, an organism. Instead of picking through the viscera of this corporate organism, as the arms length method requires, it uses a formula to apportion the corporation's income among the states and nations in which the company operates.

Thus, if one one-hundredth of a company's property, payroll and sales are located in California, then California can tax one one-hundredth of the company's income.

What is so terrible about that?

Nothing is so terrible about that. The Supreme Court continually has upheld this unitary, or formula, method as a perfectly reasonable way for the states to do a very difficult job, without enlisting every third person in the state as a tax auditor. Legal commentators increasingly are urging it upon the IRS.

The unitary approach "has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to current practice", the Harvard Law Review** concluded several years ago after an exhaustive comparison of the two approaches.

For years and years, states have been using the formula, or unitary, method to apportion corporate income among themselves.

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*Burns, Jane O., "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey", The Journal of Taxation, May 1980

**"Multinational Corporations and Income Allocations Under Section 482 of the Internal Revenue Code", 89 Harvard Law Review 1202, at 1238 (1976)

Hardly anyone argues any more that the states should not do so.

IF THE UNITARY METHOD IS THE BEST WAY TO DISTINGUIGH A CORPORATION'S OREGON INCOME FROM ITS MONTANA INCOME, THEN WHY SHOULD IT NOT BE USED TO DISTINGUISH THE SAME CORPORATION'S OREGON INCOME FROM ITS CANADIAN INCOME?

What do the proponents of the pending bills say?

- They say that the unitary method taxes "foreign income". But as stated earlier, that is just semantics. The unitary method is a tool for distinguishing US from foreign income.

If the unitary method taxes "foreign income", then why do many companies choose to use it on their own?

The Caterpillar Corporation currently is in the Illinois Supreme Court trying to force the State of Illinois to let it report its income on a unitary basis. A long list of corporations, including Zenith, McDonalds, Marshall Field & Company and Continental Illinois Bank, have filed an Amici Curiae brief supporting Caterpillar. The summary of arguments from this Amici Curiae brief appear on the following pages.

We couldn't have put it better ourselves.

And if the unitary method taxes "foreign income", why did Exxon take out full page advertisements throughout the state of Alaska applauding this method, when the Alaska Legislature was considering changes in it?

- Proponents of the proposed bills say that the unitary method is complex. But compared to what? The arms length method involves probably the most Herculean accounting tasks known on earth. Some taxpayers like this complexity because it enables them to cover their tracks. This is why they don't call it complexity.

The unitary method reduces complexity and bureaucracy, both public and private, by substituting a simplified formula approach for the prodigious accounting adjustments necessary under the arms length method.

- Proponents of these bills say the unitary method causes "double taxation" of corporate income. Yet it is the arms length method that gives rise to double taxation in 52% of the cases in which it has been applied, according to the study cited on page six.

We have yet to see an empirical study of corporate tax returns that would document claims that the unitary method causes "double taxation" any more than does the arms length method. All we get are allegations and anecdotes.

EXHIBIT

Nos. 52818, 52828, 52903

IN THE

Supreme Court of Illinois

CATERPILLAR TRACTOR CO.,
CATERPILLAR AMERICAS CO.,
CATERPILLAR CREDIT CORP.,
CATERPILLAR FINANCE CORP.,
and CATERPILLAR MACHINERY CORP.,
Plaintiffs-Appellants,
Cross-Appellees,

vs.

ILLINOIS DEPARTMENT OF REVENUE,
et al.,
Defendants-Appellants,
Cross-Appellees,

and

COCA-COLA COMPANY, et al.,
Intervening Plaintiffs-Appellants.

On Appeal from the Appellate Court of Illinois, Third District.

No. 79-104

There Heard on Appeal from the Circuit Court of the Tenth Judicial Circuit, Peoria County, Illinois.

Case No. 78 L 5615

Honorable
Stephen J. Covey,
Presiding Judge.

BRIEF OF AMICI CURIAE

EDWARD C. RUSTIGAN
DAVID K. STAUB
MARTIN G. ROSENSTEIN
Attorneys for Continental Illinois National Bank and Trust Company of Chicago, Anchor Hocking Corporation, Clark Oil & Refining Corporation, Marshall Field & Company, McDonald's Corporation, Nalco Chemical Company, The Northern Trust Company, The Richardson Company, and Zenith Radio Corporation, Amici Curiae.

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Oral Argument Requested

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

ARGUMENT

I.

COMBINED REPORTING IS REQUIRED TO FAIRLY APPORTION INCOME OF A UNITARY BUSINESS

A. Apportionment on Separate Basis Cannot Be Policed

Internal Revenue Code Section 482, 26 U. S. C. § 482.

Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Taxation 106 (1975).

B. Unitary Method Essential for Fair Allocation of Profits and Losses

Edison California Stores, Inc. v. *McColgan*, 183 P. 2d 16 (Cal. 1947).

Butler Brothers v. *McColgan*, 315 U. S. 501 (1942).

II.

COMBINED REPORTING APPROPRIATELY STRESSES SUBSTANCE OVER FORM

Edison California Stores, Inc. v. *McColgan*, 183 P. 2d 16 (Cal. 1947).

Coca-Cola Company v. *Department of Revenue*, 533 P. 2d 788 (Ore. 1974).

Montana Department of Revenue v. *American Smelting & Refining Company*, 567 P. 2d 901 (Mont. 1977).

Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Taxation 106 (1975).

Mobil Oil Corp. v. *Commissioner of Taxes*, 48 U. S. L. W. 4306 (March 19, 1980).

- Proponents of these bills say the unitary method has "flaws". But the method's critics compare it to a hypothetical ideal, instead of to the actual-world alternative which is the arms length method.

Measured against perfection, the unitary method indeed does have flaws. Any formula is an approximation at best. Currencies and accounting practices which vary from country to country can be a problem. But the arms length method suffers from these same defects and more besides.

The states will make progess on these points, if they are allowed to. Measured against the actual-world alternative, the arms length method, the unitary method comes off very well indeed.

- Propdnents of these bills say the states should depend on the IRS for enforcement in this area. But the IRS is up to its ears in work already. It has more than it can handle. Audit coverage has been dropping. Some states have asked for IRS help in the past. They have gotten little in return.

Besides, the virtue of the Federal system is that it offers the Federal government the opportunity to observe and learn from practices pioneered by the states. Justice Brandeis called the states "the laboratories of democracy". Most of the major policy innovations in this century have originated in the states.

Is it really so unthinkable to the Federal government that the states may have hit upon a better way of doing something?

Law Professor Richard Pomp, a tax consultant to developing and third world nations, has written that:

> *"(T)he arm's length method, though adequate to cope with business practices of the past, is inadequate to deal with increasingly sophisticated multinational corporate structures and business practices. Necessity being the mother of invention, it is quite possible that the states, not having the manpower to implement an arms-length standard, have developed a far more appropriate tool for dealing with the multinationals."**

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*Letter from Professor Richard D. Pomp to Senator Frank Church, June 22, 1978, reprinted in Tax Notes Magazine, June 16, 1980, at 892.

We see these additional advantages in the unitary method:

- It makes tax liability depend on the substance of business activity, rather than on the vagaries of the legal forms and corporate shells which lawyers concoct. It thus discourages the diversion of corporate resources into expensive and nonproductive legal gymnastics. It encourages putting these resources to work in productive plant and equipment instead.

- It washes out transfer pricing, tax havens and other avoidance techniques which tend to shift the state tax burden onto working people, farmers and small business. We do not believe that such people should be forced to pay for more tax breaks for giant multinational corporations.

- It is simpler to administer. This eliminates wasteful bureaucracy, enables public employees to do the jobs for which they are hired and frees up resources for other pressing public business.

- It puts multinational corporations on more equal footing, at tax time, with in-state businesses with which they compete.

Mr. Chairman, the underlying issue is whether multinational corporations will be allowed to use arcane accounting devices to put themselves beyond the law. It is whether they will be able through such devices to shift the tax burden onto small businesses, farmers and working people. It is whether they will be able to tie up huge tax enforcement bureaucracies in accounting red tape, when there is other pressing public business to attend to. It is whether our tax enforcement policies will contain a built-in advantage for oil companies which drill abroad instead of here at home and for companies which build their factories abroad, instead of here in the United States.

The present bills, S.983 and S.1688, would be steps backwards on all of these points.

III A Solution

The problem with these bills is that they do not address the problem. Instead, they use the problem as an opportunity to enact sweeping tax advantages for foreign-investing multinational corporations.

The problem is that the tax systems of different jurisdictions -- states and nations -- often do not mesh. Frequently, this means that substantial corporate income falls through the cracks of the underlaps and is reported and taxed nowhere. Sometimes it means that overlapping tax systems can subject what is arguably the same income to more than one tax.

This bill purports to address the overlaps. But it does not do so. Instead, it bars the states from using what could become the most effective tool for preventing overlaps (and underlaps as well). And it bars the states from taxing certain dividends altogether.

The bills, in effect, purport to eliminate traffic accidents at crosswalks by prohibiting pedestrians from crossing the street.

The bills would not prevent tax overlaps. As mentioned above, a recent study shows that overlaps occur more often than not under the arms length method, upon which these bills would force the states to rely.

Overlaps can occur under any enforcement method. Thus, it is not methods, but overlaps, which Congress should address. At the same time, it should address the underlaps as well.

As for the latter, major corporations should be required to provide, on their Federal income tax returns, a fifty-state breakdown of their property, payroll and sales. They already provide such a breakdwon for the forty-odd states which levy a corporate income tax, so little extra paperwork would be involved. Gathering this data in one central place would enable enforcement officials to determine when corporate taxpayers were playing shell games with their income. It would also provide a basis from which allegations of overlapping taxes could be reconciled.

As for overlaps, the need is for a dispute-solving mechanism to investigate claims of multiple taxation and arbitrate the claims of the parties involved. Such a mechanism would provide a remedy for multiple taxations when it actually occurs without requiring the states to grant wholesale tax giveaways which shift more of the tax burden onto people who are pressed to the wall already.

STATEMENT OF THEODORE W. de LOOZE
Chief Tax Counsel
Oregon Department of Justice

My name is Theodore W. de Looze, and I serve as Chief Counsel for the Tax Division of the Oregon Department of Justice, which represents the Oregon Department of Revenue in tax matters. I appear today, as I appeared on December 20, 1978 at the time of the hearing on the Interstate Taxation Bill of 1977 (S. 2173) in opposition to S. 983. Oregon joins with the statement of the Multistate Tax Commission, made by William D. Dexter, General Counsel for the Multistate Tax Commission, in its opposition to this bill.

Basically, Oregon's interest lies in Title III and Title IV of the bills dealing with net income taxes and jurisdiction of federal courts. The provisions of Title III appear to be the same as Title III in S. 2173. For the record, I wish to refer to my remarks, both in the form of a prepared statement and an oral presentation made by me on December 20, 1978, which appear beginning at page 438 of the printed hearings before the Committee on the Judiciary on S. 2173. I request that those remarks be incorporated into this record by my reference thereto.

SUMMARY

Oregon opposes S. 983 for at least the following reasons:

1. While S. 983 obstensibly sets up some guidelines, the bill does so at the cost to the states of exempting large amounts of income.

2. S. 983 takes a significant step backwards towards destroying the unitary or combination method of reporting.

3. S. 983 discriminates against intrastate and domestic businesses which fully account for their income.

4. S. 983 will reduce state revenues, including that of Oregon.

5. S. 983 will create a hardship upon Oregon in allowing cases to be heard in the United States Court of Claims, unless that court is a traveling court.

FULL ACCOUNTABILITY VERSUS EXEMPTION OF TAXABLE INCOME

Oregon's position on this bill, as well as on S. 1688 is that Oregon should be free to determine under federal and Oregon constitutional standards that portion of a corporation's total net income attributable to the corporation's activities in Oregon, and then to give such preferential treatment as Oregon determines is proper under its tax policy.

To accomplish this, Oregon is firmly behind the use of the unitary or combination method of reporting and opposes any gross exemption of income such as is represented by this bill. What this bill says to the states is that the federal government has a perfect right to determine state fiscal policy and to exempt any amounts of otherwise constitutionally taxable income.

Oregon and other states consistently have asserted before various congressional committees over the last several decades that the business world should be fully accountable as to reporting their income. Simply stated, this means that state taxing methods must provide for the determination of the total income of the economic unit, whether domestic or international in scope. Next, that the rules as to jurisdiction and assignment of income must coincide. In other words, if under the United States Supreme Court tests, there are not sufficient privileges, opportunities and benefits enjoyed by a taxpayer in a state or country to warrant the assertion of taxing jurisdiction, then the attribution of income rules should provide no taxable income assignable to that jurisdiction. If there is jurisdiction to tax, income is assigned accordingly, as the apportionment formula dictates, regardless of whether the jurisdiction determines to tax such income. Where there are activities that take place in a state that has no jurisdiction to tax, the formula may either eliminate the activity from both the denominator and numerator of the appropriate apportionment factor, or use a throwback rule, such as is used in the Uniform Division of Income for Tax Purposes Act.

To the extent that S. 983 does not meet the criteria set out above, it fails to provide the kind of uniformity and accountability which Oregon will continue to insist upon in any federal legislation that might be proposed or enacted.

Section 301.

Section 301 sets an upper limit on the amount of a corporation's income that may be taxable by a state, except for excluded corporations. It provides for the apportionment of a corporation's "base", which is the net income subject to apportionment under the laws of the taxing state, except as limited by sections 301 or 302. To the apportionable income is added allocable income. In effect, then, section 302 and the rest of the title must be examined to see what the limitations are on the amount of income that comes within the taxing authority of a state.

Section 302.

This section hits hard at Oregon, especially when combined with section 303. It first assigns to the commercial domicile domestic dividends from payor corporations owned by less than 50 percent. Oregon believes that the general rule of law now supported by the United States Supreme Court decisions is that the state of commercial domicile has no general, overall and exclusive claim to tax dividends. If a corporation is engaged in interstate commerce, whether commercially domiciled in Oregon or elsewhere, and that dividend income is business income under the Uniform Division of Income for Tax Purposes Act, Oregon includes the dividends in the apportionable tax base and divides it with the other states. Oregon is not a heavily "commercial domicile" state; Oregon would lose revenue under this provision. Furthermore, Oregon believes that this provision is not fair and that the commercial domicile rule should be abandoned. It does not fairly reflect the business activities that give rise to the income.

The second provision in section 302 is an outright exemption of dividends received by corporations owning 50 percent or more of the payor corporation. This means for all practical purposes the creation of subsidiaries in order to create dividend income. Neither the dividends, whether domestic or foreign, would be taxable. In addition, section 302 provides that no foreign source income of the dividend paying corporation is apportionable or allocable to any state. This would preclude both a combination method of including foreign source income in the apportionable tax base, and the apportionment method used by Vermont in the recent Mobil Oil Company case, where apportionment was upheld by the United States Supreme Court.

Section 303.

Section 303(a) uses "combination" and "consolidation" interchangeably. There are differences, and for the most part, states are constitutionally required to use combination where they do not have jurisdiction over all the affiliated corporations. In consolidation, all of the affiliated corporations are treated as one taxpayer, which is alright for federal jurisdiction, but not for state jurisdictional rules.

Section 303(b) would knock out Oregon practice of including in the combined group a corporation, whether domestic or foreign, where substantially all of the income of the affiliated corporation is derived from sources without the United States. This would include the so-called "80-20" corporations.

It would also preclude Oregon from combining "excluded corporations" even though they might be very, very unitary in their operations. For example, the telephone companies come within this exclusion. Also, where a corporation is required to have a transportation subsidiary which is basically a part of their overall unitary operation, the subsidiary could not be combined. Likewise, where a retail sales corporation or corporations have created a finance subsidiary for the purpose of making more favorable borrowing of money, all of which is used in the unitary business, such a subsidiary could not be combined.

All of these provisions simply allow the corporations to set up their business practices in such a way as to shelter large amounts of income. Not to be forgotten is the bill's definition of "foreign source income", which goes far beyond other bills in including all types of "passive" income in addition to dividend income.

Section 302 thus exempts from income taxation all income from intangible properties which constitute dividends from corporations in which the taxpayer owns 50 percent or more of the voting stock and any dividends attributable to "foreign sources" under sections 861, 862 and 863 of the Internal Revenue Code of 1954. Likewise, it exempts interest derived from sources outside the United States as determined under the Internal Revenue Code and other income from intangible properties and the sale of tangible or intangible properties located outside the United States.

Section 303 strikes what ultimately might be a death blow at the combination method in excluding corporations whose income is substantially derived from sources without the United States. This will easily lead to the charge of discrimination by corporations otherwise fully combinable. It is doubtful that even the United States Congress could make such a distinction stick in the face of a constitutional attack.

The provision in subsection (c) of section 303 allowing combination or consolidation on a basis acceptable to both the state and the taxpaying corporation gives the corporation the best of all possible worlds. The committee should be aware that in the Illinois Supreme Court, Caterpillar Tractor Company is asserting worldwide combination as its statutory right under the Illinois tax laws. This is another possible situation where discrimination could be claimed. Certainly it creates another avenue of nonuniformity.

EXAMPLES OF INCOME DIVERSION

In at least two cases, there are outstanding examples of how a company computes taxable income in such a way as to preclude attribution to a state. In the Mobil Oil Corporation v. Commission of Taxes of Vermont, decided March 19, 1980, and in ASARCO v. Montana Dept. of Rev., 567 P2d 901 (1977) the technique was the same. Both states required the reporting of federal taxable income. The extent to which this included foreign source dividends is not shown, but presumably they would include dividends only to the extent taxable under the United States Internal Revenue Code. It certainly included the deduction of all expenses. From this, the companies subtracted so-called "nonapportionable income" which included dividends, interest and foreign taxes. Because this figure, a gross figure, is subtracted from a net figure, for some years the result was that there was no income attributable to activities in the state. (See Appendix A) In the Montana case, the subtracted income was added back and apportioned by an apportionment formula which in effect apportioned away from Montana income attributable to other jurisdictions. (See Appendix B) In the Vermont case, the original calculations are shown in

Appendix C. After the add-back, the apportionment formula still apportioned away from Vermont income attributable to other jurisdictions. In each case the amount of income taxable changed substantially. Vermont and Montana activities were treated exactly the same as out of state activities under the states' methods.

FEDERAL POLICY V. STATE POLICY AND THE CONSTITUTIONAL QUESTION

The fact that the federal government exempts income is not sufficient reason to require that the states must follow suit. If it is federal policy to encourage commerce by exempting income, let the federal tax laws provide the exemption. Congress should not pay for implementation of federal policy by limiting state taxing jurisdiction. If a state imposes an otherwise constitutionally valid tax, one which complies with the Commerce Clause and with the Fourteenth Amendment, to cite the most frequently alleged grounds for invalidity, there is still no clear and concise authority by any court, including the United States Supreme Court, that a state may not impose that tax under the powers reserved to it by the Tenth Amendment of the Constitution of the United States. The United States Supreme Court itself has stated that, in the case of the corporation income tax, the tax is imposed after commerce has come to rest.

JURISDICTION OF FEDERAL COURTS

Section 401 gives the Court of Claims jurisdiction to review de novo any issues relating to a dispute arising under the bill or under Public Law 86-272 as amended. Petitions may be made within 90 days of the decision of a state administrative body from which the only appeal is to a court. The findings of fact by the state administrative body are to be considered with other evidence of the facts.

In Oregon, the Department of Revenue holds administrative hearings which do not create a formal record. The taxpayer appeals from the Department of Revenue order to the Oregon Tax Court. Here he receives a de novo review with a full trial of all the facts and argument of questions of law. A decision of the Department of Revenue is not binding on the Tax Court. The Tax Court is unique in that it tries solely tax questions. Nothing would be gained by the provisions of Title IV giving jurisdiction to federal courts.

In addition, there is no indication that the court would be a traveling court coming to Oregon or the Pacific Northwest to hear cases. It would be a financial and time consuming burden upon the State of Oregon to have to go to the Court of Claims to try its cases concerned with apportionment and allocation of multistate and multinational corporations.

CONCLUSION

S. 983 has no appeal to Oregon. It virtually ignores the testimony of the states previously held on S. 2173. It serves only to create exemption and reduce uniformity of taxation. It throws the taxation of income on the state level into the Internal Revenue Code with all of its varied and changing provisions as to what constitutes foreign source income, what constitutes dividends, and what corporations may be consolidated. The bill can do nothing but create arbitrary rules of taxation which discriminate against those corporations and citizens who are required to report their full taxable income for attribution to states having taxing jurisdiction. It results in multistate and multinational corporations not paying their fair share of state income taxes. It increases state administrative costs and does not relieve multistate and multinational corporations from compliance burdens. It will cost Oregon tax revenues of at least 25 to 30 million dollars a year. The bill should be tabled.

APPENDIX A

Apportionable income (or loss)was apportioned to Montana by a three-factor formula to determine the percentage attributable to Montana sources:

1967

Federal Taxable Income	$60,527,768		
Nonbusiness Income Deducted	45,169,221		
Apportionable Income	$15,358,547		
Montana percentage (1.7674) x $15,358,547 =		$ 271,447	
Income from Montana securities allocated to Montana		6,385	
Net Income from Montana Sources		$277,832	

1968

Federal taxable income	$ 62,531,929	
Nonbusiness income deducted	62,548,620	
Apportionable loss	(16,691)	
Loss apportioned to Montana	(307)	(1.8367%)
Income from Montana securities allocated to Montana	7,288	
Net income from Montana sources	$ 6,981	

1969

Federal taxable income	$ 92,480,382	
Nonbusiness income deducted	76,869,974	
Apportionable income	15,610,408	
Income apportioned to Montana	302,982	(1.9409%)
Income from Montana securities allocated to Montana	3,082	
Net income from Montana sources	$ 306,064	

1970

Federal taxable income	$115,219,427	
Nonbusiness income deducted	115,584,872	
Apportionable loss	(365,445)	
Loss apportioned to Montana	(7,324)	(2.0042)
Income from Montana securities allocated to Montana	4,903	
Net loss from Montana sources	$ (2,421	

APPENDIX D

The bulk of the tax effect of the Department's action is in adding back into apportionable income that income determined by the Department to be business income and apportionable under its 1967 regulations. Figures for each of the years are as follows:

1967

1.	Reported income.	$ 277,832
2.	Adding back business income.	1,029,035
3.	Combined reporting only.	265,563
4.	Adding back business income and combining.	972,092

1968

1.	Reported income.	6,981
2.	Adding back business income.	1,176,823
3.	Combined reporting only.	120,093
4.	Adding back business income and combining.	1,125,987

1969

1.	Reported income.	306,064
2.	Adding back business income.	1,885,233
3.	Combined reporting only.	346,702
4.	Adding back business income and combining.	1,827,489

1970

1.	Reported income.	(2,421)
2.	Adding back business income.	2,381,685
3.	Combined reporting only.	(125,322)
4.	Adding back business income and combining.	2,280,491

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APPENDIX C

Appellant's original calculations for the years in question were as follows:

Year 1970		
Federal Taxable Income		$220,035,244.23
Less:		
Nonapportionable Income		
Dividends	$174,311,073.60	
Interest	10,020,793.51	
Foreign Taxes	12,221,476.88	
Total		196,553,343.99
Apportionable Income		$23,481,900.24
Net Income Allocable to Vermont		20,361.11
Total Vermont Tax		$1,221.67
Year 1971		
Federal Taxable Income		$308,253,570.02
Less:		
Nonapportionable Income		
Dividends	$232,817,006.05	
Interest	12,609,826.23	
Foreign Taxes	84,659,578.65	
Total		$330,086,410.93
Apportionable Income		($21,832,840.91)
Net Income Allocable to Vermont		0.00
Total Vermont Tax (minimum tax)		$25.00
Year 1972		
Federal Taxable Income		$232,825,728.27
Less:		
Nonapportionable Income		
Dividends	$280,623,403.93	
Interest	3,905,208.04	
Foreign Taxes	38,260,249.40	
Total		$322,788,861.37
Apportionable Income		($89,962,133.20)
Net Income Allocable to Vermont		0.00
Total Vermont Tax (minimum tax)		$25.00

App. 27, 34; 51, 48; 66, 62.

Senator BYRD. We have one final panel, Mr. Robert L. McNeill, executive vice chairman, Emergency Committee for American Trade; Mr. Albert R. Doyle, chairman, Tax Committee of the National Foreign Trade Council, Inc.; Mr. Sadami Wada, assistant vice president, Sony Corp. of America; Mr. Roger Kirk, vice chairman of the board, Brown & Williamson Tobacco Co., and Mr. Reuben L. Johnson, director of legislative services, National Farmers Union.

Who are we missing?

Mr. Johnson is not here, but he has a statement which, without objection, will be printed in the record.

Gentlemen, you may proceed as you desire.

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. MCNEILL. Mr. Chairman, I am Robert L. McNeill, executive vice chairman of the Emergency Committee for American Trade.

I am pleased to be here today to testify in support of S. 1688.

ECAT is an organization of 64 U.S. companies with extensive international business operations. In 1979, worldwide sales by the companies that I represent totaled about $450 billion, and they employed approximately 5 million people.

Mr. Chairman, all of the comments that I have today have been made by earlier witnesses, and I will not take your time or the time of the committee to repeat them. I would appreciate my statement being incorporated in the record.

Senator BYRD. It will be received and incorporated.

Mr. MCNEILL. If I may, I would just like to read to you the final paragraph of my formal statement. What it is is a quote from a gentleman, Allen R. Short, who is director of the tax policy branch of the Canadian Department of Finance. He made the following remarks about the unitary tax system at a lecture at Fordham University in 1976. I would simply like to read his quote:

> I am going to play devil's advocate, a role that I enjoy, and start off with the position that I feel badly that the unitary system has had such rough treatment. Therefore, I would like to find some way to defend and support it. I would like to give it a conditional blessing with several if's.
>
> If the tax system of all countries in the world were identical, if the tax accounting practices did not differ, if everybody could agree on the principles of amalgamation, if everybody could agree as to what a unitary business was, if it was not necessary to determine the nature or quality of the income for tax purposes, i.e., whether it was a manufacturing resource profit, an export profit, or royalty, if countries could agree on exactly the same formula for allocating income, if the price of labor and the cost of capital were identical in all countries, if we had a single monetary unit in the world, if there were no minority interests in any subsidiary companies within a group, if the existing scheme did not work, and if the unitary system was not inestimably arbitrary, I would support it.

I thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. McNeill.

You summed up your case in very few words and rather to the point. Thank you.

Mr. Doyle?

STATEMENT OF ALBERT R. DOYLE, CHAIRMAN, TAX COMMITTEE OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. DOYLE. Thank you, Mr. Chairman.

My name is Albert Doyle. I am chairman of the tax committee of the National Foreign Trade Council, which is a nonprofit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests in all aspects of international trade.

I am appearing here on behalf of the council, and I welcome this opportunity to comment on S. 1688 and S. 983.

The two bills before the subcommittee, although different in scope, address an issue which has been before the Congress, and which the U.S. Supreme Court has on several occasions referred to Congress for legislative consideration.

Although the National Foreign Trade Council recognizes the need for Federal legislation in regard to many issues involved in State taxation of interstate and foreign commerce, and supports the enactment of S. 983, because of the specific interests of the council in foreign trade and investment, our comments will focus on the more narrow issue of State taxation of foreign source income in S. 1688.

Mr. Chairman, in our view, some States have taken an unreasonable position on taxing foreign source income of both foreign-owned and U.S. businesses. Recent court decisions indicate that the courts are reluctant to enter this area, and we believe that Congress must act.

Some constitutional arguments have been rejected by the courts, as has been mentioned by the previous speaker. We believe that the issue here is the propriety and wisdom of the present system.

We support both parts of S. 1688, that is, the limitation of State taxation of foreign income to that taxable under the U.S. Internal Revenue Code, and second, the taxation of foreign source dividends only to the extent that the dividends are taxed by the Federal Government.

This legislation would not be removing a long standing or prevalent method of State taxation. Some of the comments I have heard today would indicate that we are undermining the States' abilities to collect revenues. We don't see it that way at all. This is a comparatively recent phenomenon, and has been used in only a few States, most notably, as you have heard, Mr. Chairman, in California.

The enactment of this bill would not affect the unitary method of taxation employed by States that include income from domestic operations, but do not include income from operations of foreign affiliates in the State combination. Many States do this.

Also, we don't see this as a States' rights issue. We don't believe the enactment of this legislation would affect the legitimate rights of the States to impose taxes. We are opposed to overreaching.

Also, I heard a comment earlier about companies who allegedly take the position that they shouldn't pay any State taxes. I am not aware of any such companies. It is possible that under some State laws some companies in fact pay no taxes or are subject to relatively low tax burdens, but I don't know of anybody who is advocating that companies should not pay State taxes.

Mr. Chairman, we have offered a written comment for the record, and with your permission I would like to submit it.

Senator BYRD. It will be received.

Mr. DOYLE. If I might go on, I would just like to comment on something that I heard earlier.

Secretary Lubick, to my surprise, in opposing the dividend portion of this bill, described the difficulties of the Treasury in handling it. He used terms like "horrendous complexity" and "mind-boggling provisions."

Now, I have been involved in Federal taxation, and I well agree that many provisions of our tax law are indeed mind-boggling, but we do not see the dividend provisions of this bill in that category. We think that they are relatively straightforward, and would look forward with interest to seeing the Treasury's explanation of why they have difficulty in handling this particular subject.

Senator BYRD. I have found that the Treasury has difficulty in handling any matter to which they are opposed, but they have no difficulty in handling matters as complicated as carryover basis, which no one else can understand. [General laughter.]

Mr. DOYLE. I certainly agree with that, Mr. Chairman.

In conclusion, although it is obvious that a total resolution of the many issues of State taxation of interstate and international business will not be attained unless legislation similar to S. 983 is enacted, the enactment of S. 1688 could provide a helpful first step toward resolution of this overall problem.

Mr. Chairman, thank you for this opportunity to present the views of the National Foreign Trade Council on this important legislation.

Senator BYRD. Thank you, Mr. Doyle.

The next witness.

STATEMENT OF SADAMI (CHRIS) WADA, ASSISTANT VICE PRESIDENT, SONY CORP. OF AMERICA

Mr. WADA. Mr. Chairman and members of the committee, Sony Corp. of America appreciates the opportunity to speak in support of S. 1688. My name is Sadami Wada, assistant vice president of Sony Corp. of America.

Sony finds it very difficult to understand why we have to be penalized for having invested in manufacturing color televisions in California. Sony has over 4,400 employees throughout the country; 1,600 are engaged in manufacturing color televisions in San Diego, Calif., and 1,200 in manufacturing magnetic tape in Dothan, Ala. We replaced imports with U.S.-made Sony products.

Further, we have planned to export in excess of $100 million in U.S.-made Sony products in this fiscal year.

Contrary to some of the anticipations by friends, we proved excellent productivity, and we have enjoyed reliable quality. Innumerable American companies came to visit San Diego, discussing with us how to achieve this excellent productivity and reliable quality in California.

Now, we believe we have encouraged many other Japanese to invest in the United States, not to be afraid or concerned with U.S. labor. With a Sony product, you don't have to worry whether they were made on Monday or Friday. They are consistently reliable. But Sony has been penalized in California for having contributed to job opportunities, economic growth, and greater tax basis.

The famous Jones report by the task force of the Ways and Means Committee of the House reports Japan can invest in U.S. production facilities, thus returning capital and jobs to America. It further reports:

> We repeat our belief that the need to find a solution to these trade problems is urgent. We hope that Japan will take additional steps as soon as possible to reduce its trade barriers and increase its investment in the United States.

This is a famous Jones' report, almost every Japanese bureaucrat has read this, either in Japanese translation or the original English.

Your Ambassador, Mike Mansfield, also many times urged Japan to invest in the United States. But currently, once we invest, like in California, or as in California, we can be hit by worldwide unitary tax. Your Congress urges the Japanese autos to invest in the United States. There is no guarantee that they won't be hit by worldwide unitary tax.

The California State Legislature has shown their wisdom by introducing AB525, which would stop the unitary tax. This has earned 93 ayes against only 17 noes. This legislature further finds that,

> the inclusion of foreign income in determining the tax liability of foreign economic interests wishing to invest in California has frequently resulted in unfair taxation of foreign based taxpayers, and consequently acted as an impairment to investment and hindered the creation of new opportunities for employment and diversification of the economic base of this state.

I would very much hope that S. 1688 will be passed so that we would have no fear of being hit by worldwide unitary tax.

Thank you very much.

Senator BYRD. Thank you, Mr. Wada.

In how many States does Sony have plants?

Mr. WADA. Plants are only in California and the State of Alabama. California, 1972, and in order not to get burnt again, we selected the State of Alabama, and we have been trying to balance, until the Governor signs this bill.

Senator BYRD. Did you take a look at the State of Virginia? [General laughter.]

Mr. WADA. I wish we had done that, sir. [General laughter.]

Governor Wallace was calling us from Alabama, and he said he will send a jet and pick us up and so forth. We were almost going to go into Tallahassee, Fla., and Congressman Gibbons from Florida, who was in the Ways and Means Committee hearing, he said, why did you not come to Tallahassee? But Governor Wallace somehow had a hand over the rest. But we would like to expand investing and encourage others as well.

Senator BYRD. Virginia has a color television plant at the city of Suffolk.

Mr. WADA. Yes.

Senator BYRD. Thank you, sir.

Mr. WADA. Thank you.

Senator BYRD. The next witness is Mr. Roger Kirk, vice chairman of the board, Brown & Williamson Tobacco Co., a company which does have a plant in Virginia.

Mr. KIRK. Thank you, Mr. Chairman.

Senator **Byrd**. A very fine plant, I might say, with very fine employees, many of whom I know personally. We are glad to have you, Mr. Kirk.

STATEMENT OF ROGER KIRK, VICE CHAIRMAN OF THE BOARD, BROWN & WILLIAMSON TOBACCO CO.

Mr. **Kirk**. Thank you, Mr. Chairman. It is a pleasure to be here and to have been invited.

Mr. Chairman and members of the subcommittee, I am Roger Kirk, vice chairman of the board of Brown & Williamson Tobacco Corp., which manufactures tobacco products. It is a subsidiary of BATUS, Incorporated, which is owned by BAT Industries, Ltd., a United Kingdom Corporation.

BAT is England's third largest industrial and employs more than 250,000 persons on six continents. It is involved in five separate and unrelated lines of business, tobacco, paper, retailing, cosmetics, and packaging.

BAT is joined in its support of S. 1688 by 58 of England's largest corporations having U.S. affiliates and which have invested in this country and employ its citizens. I have been asked to forward that group's written statement for the record which I will deliver to the Committee on Finance staff.

Senator **Byrd**. Without objection, it will be received.

[The material referred to, to be submitted, follows:]

LETTER TO BE SENT TO SENATOR BYRD, TYPEWRITTEN, BY ROGER KIRK, JUNE 25, 1980

Senator HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Again, let me express my appreciation for your interest and assistance in scheduling the hearings on this legislation before the Subcommittee on Taxation and Debt Management on June 24, 1980. The opportunity to discuss this legislation and the need for it is most important.

In reviewing the testimony given by the opponents of the bill it seems that two major points were raised which need clarification: (1) Senator Church, among others, stated that the legislation would prohibit the States from using the unitary method of accounting which the majority of States do utilize; and (2) that the legislation would be a violation of States' Rights. Both contentions are mistaken.

The majority of States use some method of formula apportionment to determine the tax liability of the unitary operations of a single, multistate corporation. A substantial number of States extend the concept of formula apportionment to a controlled group of corporations when the operations and management of the group are "unitary" in character, i.e., integrated to accomplish a single business purpose or related business purposes. It is commonly understood that those States that apply formula apportionment to the unitary operations of related corporations are said to employ the "unitary method" of taxation.

California, and as explained at the hearing, to some extent Alaska, Idaho, Montana, North Dakota, and Oregon, take the unitary method one step further, too far, in fact. They extend the application of unitary apportionment to the international operations of foreign affiliates of United States corporations, even though those affiliated corporations may be involved in unrelated non-unitary lines of business and do no business in the United States, let alone the taxing State. That system has become known as the "worldwide combined reporting system."

The Federal Government does not tax the foreign source income of a foreign affiliate of a United States corporation until that income is repatriated, or deemed paid back to the United States by application of Subpart F of the Internal Revenue Code of 1954. In contrast those States which use the worldwide combined reporting system tax currently, as earned domestically, the income of a foreign affiliate even though that foreign affiliate does not do any business in the United States and derives all its income outside this country.

S. 1688 would conform the State rules to the Federal rules with the very narrow area of the *time* at which States tax the foreign source income of foreign affiliates. It obviously does not have the effect of prohibiting the use of the unitary method.

The term States' Rights was also used by the opponents and much was made of the fact that one proponent witness had referred to the States as "political subdivisions." While you were absolutely correct in pointing out that the States are not political subdivisions of the United States, it should be explained that the reference was to the States as political subdivisions "within" the United States, not "of", the former being how they were described in the United States-United Kingdom Tax Treaty for example.

What is important here is the word "United." While the States are certainly separate and sovereign, and certainly have, as Senator Church pointed out, certain fundamental rights, the United States must have the fundamental right in the very narrow and limited area of taxation of international commerce to speak in one voice. If not this country would have fifty-one different tax policies regarding international commerce, while its allies, such as England, would have only one.

Several opposing witnesses also claimed that the Supreme Court of the United States has in recent decisions upheld the constitutionality of the worldwide combined reporting system. That is not the case. The Court has recently decided two cases involving the unitary method of tax assessment. In the decision in *Mobil Oil Corporation* v. *Commissioner of Taxes of Vermont,* U.S. Supreme Court, No. 78-1201, (March 19, 1980) the Court made it clear that: "The linchpin of apportionability in the field of state income taxation is the unitary business principle." Slip Opinion 13.

Of course, the unitary business principle requires an underlying unitary and related business. The Court clarified that its decision did *not* mean that: "All dividend income received by corporations operating in interstate commerce is necessarily taxable in each state were that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing state, due process considerations might well preclude apportionability, because there would be no underlying unitary business." Slip Opinion 15.

It is the application of the worldwide combined reporting system to non-unitary unrelated lines of business engaged in by affiliated corporations, which produces the perverse and adverse results which the legislation would eliminate. The Supreme Court in *Mobil* recognized the lack of uniformity between States as to taxation of dividends and said: "Congress in the future may see fit to enact legislation requiring a uniform method of state taxation of foreign dividends. To date, however, it has not done so." Slip Opinion 22-23.

The more recent decision in *Exxon Corp.* v. *Department of Revenue of Wisconsin,* U.S. Supreme Court No. 79-509 (June 10, 1980) did not even involve foreign source income. The Court held that States were free to apply the unitary method if a company is a unitary business. Slip Opinion 14. It did not discuss the worldwide combined reporting system nor its use.

The record substantiating the need for the passage of S. 1688 is overwhelming. It should be considered on its merits without confusion. We appreciate the continued opportunity to provide information.

Sincerely yours,

Roger Kirk.

Statement of the Unitary Tax Campaign, LTD.

Mr. Chairman, Members of the Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally, we are pleased to be able to submit written comments in support of S. 1688 on behalf of the fifty-eight United Kingdom companies listed on the attached "Exhibit One" which have formed the Unitary Tax Campaign, Ltd. Those corporations have invested heavily in the United States. They have affiliates in the United States participating in American trade and employing American citizens.

These companies are all members of corporate groups with affiliates operating worldwide in many diverse lines of business. They became exposed to the vagaries of the method of corporate tax assessment that has become known as the "worldwide combined reporting system" by virtue of having operations in the few individual States within the United States that use such system.

As has been explained many times in the record of the United States-United Kingdom Income Tax Treaty, and this legislation and its House of Representatives counterpart, H.R. 5076, most of the individual States use some apportionment formula to determine the tax liability of the unitary operations of a single multistate corporation. A substantial number of States enlarge that formula to a controlled group of corporations when the operations and managment of the group are unitary in nature, i.e., integrated to engage in one business or have related business purposes. That application has become known as the "unitary method" of taxation.

A few individual States, mainly California, and Alaska, Idaho, Montana, North Dakota, and Oregon, somewhat, carry the unitary method one additional step. They apply unitary apportionment to the worldwide operations of foreign affiliates of United States corporations, even when those corporations are involved in non-unitary and unrelated lines of business and are not conducting business in the taxing State, or even in the United States. It is this unwarranted extension of the unitary method to worldwide operations of affiliated corporations that has become known as the "worldwide combined reporting system."

The extent of the unwarranted intrusion into international commerce can be illustrated by examining the Proposed Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations of the California Franchise Tax Board. While the complete text was included in the record of the hearing on H.R. 5076, before the House Of Representatives Committee on Ways and Means on March 31, 1980, in the statement of Arthur Andersen & Company, the following provide good examples of the lengths to which the dictates of California are imposed on corporations which it forces to combine, though they are not doing business there and are engaged elsewhere in unrelated lines of business:

> 3. Adjustments will be made to the profit and loss statement to conform it to the tax accounting standards required under the California Revenue and Taxation Code.
>
> 5. Business and non business income as determined under California law will be identified and segregated.
>
> 6. Nonbusiness income will be allocated to a jurisdiction on the basis of the rules provided for in the Uniform Division of Income for Tax Purposes Act as adopted by California. (emphasis ours)

In addition, those Guidelines require conformance of accounting methods, inventories, and depreciation to California specifications, though they vary from established procedures throughout the world.

The corporations which make up the Unitary Tax Campaign bannded together to support the United States-United Kingdom Income Tax Treaty because in Article 9(4) the United States and the United Kingdom agreed not to use the worldwide combined reporting system to assess the taxation of corportations of either country. The orignal Treaty would have applied that limitation to not only the Federal Government, but the individual States of the United States, as well.

The Unitary Tax Campaign supported Article 9(4) because it would have prevented double taxation, would have removed obstacles to investment in the United States and would have served to not only retain employment there, but to increase the number of job opportunities. Of course, that is precisely the purpose of a tax treaty; to avoid double taxation and prevent evasion of taxes without hindering international trade and investment.

In consideration of the Treaty by the Senate Foreign Relations Committee, Senator Church attempted to remove the limitation of Article 9(4) by reservation. That amendment was defeated by a vote of ten to five. When the Senate debated the Treaty in June, 1978, Senator Church again proposed the reservation regarding 9(4) and the reservation was again defeated by forty-four votes to thirty-four. In the vote by the Senate on the Treaty, the following day, forty-nine voted in favor, thirty-two against; five votes short of the required two-thirds majority. After several days of discussions the Treaty was ratified by a vote of eighty-two to five, with the Church reservation included, the Treasury Department having capitulated to gain passage of the Treaty with no further hindrance.

Thus when the House of Commons considered the Treaty with the amended Article 9(4), it was forced to do so with a major portion of the Treaty absent. In the unamended Treaty the Federal Government had agreed with England that it would not use the worldwide combined reporting system, which it does not in fact use, and the same rule would apply to the States. In the amended Treaty, the individual States were free to use the worldwide combined reporting system, thereby creating a potential for fifty-one different tax policies. The House of Commons, did, however, approve the Treaty with the confidence that the United States Congress fully intended to examine the adverse effects of the application of the worldwide combined reporting system by the few individual States.

Michael Grylls, Member of the House of Commons, made that point quite clear in his speech on the Treaty located at pages 189-190 of the February 18, 1980, Hansard, which is the official report of the House of Commons debates:

> It is crucial for business relations between two countries as close as Britain and the United States that this matter should be resolved. Otherwise we risk generating friction not only between our business enterprises but between our countries. We explained to people in Congress, as fellow parliamentarians, the real problem that existed and that the change they had made in the treaty had created a problem for us. We appealed for their help to try to solve it.

> It is not right for individual states to speak with different voices on matters of international business. We are relying on them. Britain has the biggest investments of any foreign country in the United States. We are the closest of friends. I am sure that we want to go on investing and expanding business there. I am sure that this also benefits the United States.

Member of the House of Commons, Roger Moate, pointed out that it was not only England that was concerned:

> It is a bad international precedent for the British Government or any other nation to have to look to perhaps 50 states in the United States for an understanding of the way in which we are to conduct our international tax affairs. That cannot be right. I am sure that the United States understands that this is a grossly unsatisfactory situation.
>
> It is a bad international precedent, because of the damage that it could do all world trading nations. page 194, February 18, 1980, Hansard

Since approval of the Treaty the nine governments which make up the European Economic Community have indicated their strong arguments against the worldwide combined reporting system and have in correspondence to the Department of State on March 19, 1980, urged:

> ...you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

The members of the Organization for Economic Cooperation and Development, which include the United States, have recognized that limitation of the worldwide combined reporting system is necessary. Its Model Income Tax Convention and the 1974 Guidelines for Tax Treaties Between Developed and Undeveloped Countries, prepared under the auspices of the United Nations adopt the arms length method as used by the Federal Government as the standard.

During the Senate debates, opponents of Article 9(4) and proponents of the Church reservation raised the point that since that provision of the Treaty would limit the States in their application of the worldwide combined reporting system, that problem should be addressed legislatively by both Houses of Congress.

In August, 1979, S. 1688 and H.R. 5076 were introduced. The first section of those two bills would conform the State rules to the Federal rules regarding the taxation of foreign source income so as to have uniformity on the one issue of the time at which the foreign source income of foreign affiliates of United States corporations is taxed. The second section of the legislation concerns the extent to which the States may tax dividends paid to United States parent corporations from overseas affiliates.

Though the record as to why this legislation should be enacted is complete and contains extensive discussion of the reasons support for it is so widespread in the United States and abroad, the members of the Unitary Tax Campaign feel that there can be no reasonable justification for a tax system which:

(a) apportions income on the basis of any one or more of a number of factors not necessarily directly related to actual income and the expenses of the business;

(b) taxes income outside of and not in any way related to the taxed companies' operations;

(c) uses bases and factors which can be and are varied by the tax authorities from year to year;

(d) calls for accounts and information on a basis totally different from any other tax system and even beyond the kind of information readily available to an international trading company, except at unacceptably huge additional costs;

(e) with sèperate tax authorities using the same basic method, but with different factors and definitions in their calculations, can lead to multiple-taxation - even of extra-territorial income;

(f) could, for example, place a U. K. company in the impossible position of being requested to disclose classified information on the details of its operations when the group or part of it is involved in the defence equipment industry;

(g) is difficult to administer and is an inaccurate method of apportioning the income of multinational business among taxing jurisdictions;

(h) may result in the State taxing income of the multinational enterprise that is not derived from or substantially related to the operation of an affiliate of the enterprise in the taxing State;

(i) to produce equitable results requires equality of factors combined, when cases of truly unitary entities with equal rates of profit, property, and labor, occur seldom if ever in the context of multinational business.

The members of the Unitary Tax Campaign have substantial investments in the United States. They employ a large number of Americans and purchase materials and use services provided by other American corporations. We do not only consider the worldwide combined reporting system unfair, but also feel that it impedes industrial investment and decreases job opportunities as a result.

We encourage the passage of S. 1688, not to be granted some sort of preference, which does not exist, but to avoid being penalized for our desire to increase our investment in the United States. It should be pointed out that investment is of an industrial and commerical nature, and not involved in the purchase of American farmland as some opponents have contended.

Thank you.

E. John Symons
Deputy Chairman,
BAT Industries, LTd.
on behalf of the Unitary Tax
Campaign

"Exhibit One"

UNITARY TAX CAMPAIGN, LTD. MEMBERS

Albright & Wilson Limited
1 Knightsbridge Green
London SW1X 7QD

Allied Breweries Limited
Allied House
156 St. John Street
London EC1 P 1AR

Babcock & Wilcox Limited
Cleveland House
St. James's Square
London SW1Y 4LN

J. Bibby & Sons Limited
Richmond House
1 Rumford Place
Liverpool L3 9QQ

Blackwood Hodge Limited
Hunsbury Hill Avenue
Northampton NN4 1AR

BOC International Limited
Hammersmith House
London W6 9DX

Booker McConnell Limited
99 Bishopsgate
London EC2M 3XD

The Bowater Corporation Limited
Bowater House
Knightsbridge
London SW1X 7LR

BAT Industries Limited
P.O. Box 345
Windsor House
50 Victoria Street
London SW1H 0NL

Bunzl Pulp & Paper Limited
Friendly House
21/24 Chiswell Street
London EC1Y 4UD

Cadbury Schweppes Limited
1-10 Connaught Place
London W2 2EX

Cape Industries Limited
114 Park Street
London W1Y 4AB

Carreras Rothmans Limited
Oxford Road
Aylesbury
Bucks HP21 8SZ

Cavenham Limited
Cavenham House
Millington Road
Hayes
Middx UB3 4AY

Charterhouse Group Limited
1 Paternoster Row
St. Paul's
London EC4M 7DH

Chloride Group Limited
52 Grosvenor Gardens
London SW1W 0AU

Coates Brothers & Company Limited
Easton Street
London WC1X 0DP

Richard Costain Limited
111 Westminster Bridge Road
London SE1 7UE

Croda International Limited
Cowick Hall
Snaith
Goole
North Humberside DN14 9AA

Dalgety Limited
10 Upper Grosvenor Street
London W1X 9PA

Davy Corporation Limited
15 Portland Place
London W1A 4DD

The Delta Metal Co. Limited
1 Kingsway
London WC2B 6XF

EMI Limited
30 Gloucester Place
London W1A 1ES

Ferranti Electronics Limited
Fields New Road
Chadderton
Oldham
OL9 8NP

Foseco Minsep Limited
36 Queen Annes Gate
London SW1

Glaxo Holdings Limited
Clarges House
6-12 Clarges Street
London W1Y 8DH

Guest Keen & Nettlefolds Limited
Group Head Office
P.O. Box 55
Smethwick
Warley
West Midlands B66 2RZ

The Guthrie Corporation Limited
120 Fenchurch Street
London EC3M 5AA

Hansen Trust Limited
180 Brompton Road
London SW3

Harrisons & Crosfield Limited
1-4 Great Tower Street
London EC3R 5AB

Hawker Siddeley Group Limited
18 St. James's Square
London SW1Y 4LJ

IMI Limited
P.O. Box 216
Birmingham B6 7BA

Inveresk Group Limited
Clan House
19 Tudor Street
London EC4Y 0BA

Laporte Industries (Holdings) Limited
Hanover House
14 Hanover Square
London W1R 0SE

Lead Industries Group Limited
14 Gresham Street
London EC2V 7AT

London Chamber of Commerce and Industry
64 Cannon Street
London EC4

LRC International Limited
North Circular Road
London E4 8QA

Lucas Industries Limited
Lucas House
46 Park Street
London W1Y 4DJ

J. Lyons Group of Companies
Allied House
156 St. John Street
London EC1 P 1AR

Mallinson Denny Limited
130/150 Hackney Road
London E2 7QR

Metal Box Limited
Queen's House
Forbury Road
Reading
Berks RG1 3JH

Morgan Grenfell and Co. Limited
23 Great Winchester Street
London EC2P 2AX

Mothercare Limited
Cherry Tree Road
Watford
Berts WD2 5SH

Pegler Hattersley Limited
St. Catherine's Avenue
Doncaster
South Yorkshire DN4 8DP

The Plessey Company Limited
Millbank Tower
London SW1P 4QP

Racal Electronics Limited
Western Road
Bracknell
Berkshire RG12 1RG

Tube Investments Limited
TI House
Five Ways
Birmingham B16 8SQ

The Rank Organisation
38 South Street
London W1A 4QU

Ransome Hoffmann Pollard Limited
76 Jermyn Street
London SW1Y 6HU

Reckitt & Colman Limited
P.O. Box 26
Burlington Lane
London W4 2RW

Smiths Industries Limited
Cricklewood
London NW2 6JN

Stone-Platt Industries Limited
10 Grafton Street
London W1X 3LA

Tate and Lyle Limited
Sugar Quay
Lower Thames Street
London EC3R 6DQ

Thorn Electrical Industries Limited
Thorn House
Upper Saint Martins Lane
London WC2H 9ED

Tozer Kemsley & Millbourn (Holdings) Limited
28 Great Tower Street
London EC3R 5DE

Transport Development Group Limited
Kingsgate House
66 Victoria Street
London SW1E 6SR

Tricentrol Limited
Capel House
New Broad Street
London EC2M 1JS

George Wimpey & Co., Limited
Hammersmith Grove
London W6 7EN

Statement of Peter Welch

Group Finance Director

FOSECO MINSEP, Limited

Mr. Chairman, Members of the Committee, Foseco Minsep, Limited, whose headquarters are in London, England is pleased to be able to have our remarks in support of S. 1688 included in the June 24, 1980, hearing record.

Foseco Minsep has manufacturing and marketing companies in over 34 countries, supplying specialized products and technical services in all parts of the world. The largest single operating subsidiary within the group is Foseco Inc. which is located in the State of Ohio and has operations in California. Foseco, Inc., has been manufacturing and marketing specialized chemical products and technical services for the U. S. steel, foundry and non-ferrous metal industries since 1953.

Contrary to the statements of several opposing witnesses who presented oral statements at the hearing, S. 1688 would not limit the use of the unitary method of tax apportionment as used by a majority of States to assess taxes of an interstate corporation involved in a unitary business. It would limit the application by the States of the corporate tax assessment method which is known as the worldwide combined reporting system. This method computes the state income or franchise taxes of a corporation, by combining its income with that of it's affiliates worldwide, and then, for example, applying a three factor formula to determine taxable income within that State. This means that the taxable income within that State is determined on the results of affiliated corporations engaged in business in other states or countries which do not depend upon or contribute to the business of the corporation within the taxing State and which may be involved in unrelated, non-unitary lines of business.

The State of California is the leading exponent of the worldwide combined reporting system among the small number of States that use it. Foseco, Inc. is the only member within the Foseco Minsep, Ltd., group, which has operations within California. Even though our California operation is small, California's application of the worldwide combined reporting system to it provide a good example of the system's ill effects.

Foseco, Inc. is involved in only one line of business, but when combined with other group members abroad who may have different lines of business, its franchise tax for the years 1971-1974, was $35,000.00. If not so combined, and had it been assessed on its own operations its taxes would have been $9,500.00, a resulting overpayment of $25,500.00. In addition, it was impossible for Foseco to comply with the information demands of the California Franchise Tax Board, which resulted in the assessment of penalties of $6,400.00. Together, the payments have been more than four times the taxes that Foseco should have paid on its activities in California.

Not only is the extra tax burden objectionable; it is also an unfair practice to the taxpaying corporation to be judged, not only on its own line of business, but on the combination of different unrelated lines of business of affiliated corporations in other countries. Additionally, because no allowance is made for affiliated corporations which are combined and are publicly held, minority stockholders are adversely effected by this unfair taxing method since they must bear a tax burden based upon profits in which they have no share. The entire income of such publicly held corporations is combined with the taxed corporation, thus causing it to be taxed on income that is not its own.

An example of the administrative burden of attempting to comply with the worldwide combined reporting system are the outlandish requests which often result, for detailed information concerning the activities of affiliated corporations abroad, engaged in unrelated types of business. A tax-paying corporation is often forced to accept penalties because it is not possible to comply with those requests.

For the worldwide combined reporting system to produce equitable results equality of the factors combined is absolutely neccessary. Obviously, that is hardly ever the case. The differing types of currency in which the corporations forced to combine must deal produces inherent confusion. Profit rates are not the same worldwide. Costs of production, of materials, their transport, and of labor vary widely. Accounting principles are not uniform. Taxes which affect income are varied in rate and application.

It is accepted internationally, and the United States has recognized in its treaties and conventions of friendship with other countries, that a nation may only tax income earned within its boundaries or income earned by entities within its borders. It is a dangerous precedent to allow State taxing authorities to not only tax profits of corporations operating in their jurisdiction, but of affiliated corporations engaged in unrelated businesses operating abroad and outside of their jurisdiction as well. This is especially true given that the Federal Goverment does not tax foreign source income until it is returned to the United States, and relies on the arms length standard instead of the worldwide combined reporting system. With the establishment of such a precedent multiple taxation will result.

The threat of being subjected to the use of the worldwide combined reporting system and its resulting perverse and penalizing effects serves as a disincentive to investment in the United States. When appraising the desirability of investing or expanding in a State where the threat of the worldwide combined reporting system is present, prospective ventures must offer returns well above the average to overcome the tax disadvantages. The unprofitable nature of investments in the early years due to start up cost compounds this. Taxes assessed by the worldwide combined reporting system magnify the financial commitment and increase the risk surrounding a new venture. This of course, discourages new investment and new jobs.

Employment is also discouraged in States using the worldwide combined reporting system in a more direct fashion. A primary step in the use of the system by the California Franchise Tax Board, for example, is the apportionment of worldwide profits based on the ratio of payroll, sales and property in that State compared to payroll, sales and property worldwide. Management of corporations subjected to the system's abuses continually attempt to minimize their tax burden by reducing, to an absolute minimum, the payroll in jurisdictions which use it. For example, in North America, Foseco employs 1500 employees while only 20 employees are in California. This is well below the average number of employees Foseco normally has in a state with a manufacturing facility.

Foseco Minsep, Ltd. is not supporting S. 1688 to avoid paying taxes. Our support comes from the firm belief that a corporation should be subject to taxes on its income, but not on a portion of combined income including its affiliated corporations involved in unrelated lines of business in other countries.

The United States Government has been instrumental in establishing worldwide a method of taxation that does not allow such methods. Therefore, the slight limitation that S. 1688 would place on the States to conform with policies and procedures established by the Federal Government, in our opinion, is warranted. Passage of S. 1688 would result in a United States tax policy in this area of international commerce rather than potentially as many tax policies as there are States.

Thank you.

Peter Welch
Group Finance Director
Foseco Minsep, Ltd.
36 Queen Anne's Gate
London SWIH 9AR
England

Mr. **Kirk**. Thank you.

Some opponents of S. 1688 have alleged that this legislation creates a preference for foreign corporations. I would draw the subcommittee's attention for an explanation that that is not the case to the remarks of John S. Nolan at the March 31, 1980 hearing before the Committee on Ways and Means on this bill's House counterpart, H.R. 5076.

In summary of my written statement, I would like to outline the basis of our support for this legislation, which would not prohibit the use of the unitary method, but would limit the use of the worldwide combined reporting system method of corporate tax assessment. I should point out that its application by California, the leading exponent among the few individual States that do use it, has resulted in substantial savings in BAT's case.

California requires that profits be assigned to California by use of a three-factor formula utilizing sales, property, and payroll. The sum of those factors in California over the worldwide factors result in a percentage which when applied to worldwide income theoretically produces an amount of income calculated as earned in California.

For that formula to produce equitable results, it is essential that the factors be equal throughout the tax corporation's operations, and including those with which it is combined, and that those operations be related.

Though the California formula has combined operations of distinctly unrelated affiliated corporations, in our case no attempt has been made to combine domestic or international nontobacco operations of BAT worldwide. Since 1968, when the California Franchise Tax Board first required Brown & Williamson to submit ombined worldwide reports, the tax has amounted to about $2.8 nillion. If tax had been computed without regard to worldwide ctivity of its foreign parent, it would have been $3.7 million, about 1 million more, mainly because Brown & Williamson is relatively nore profitable using lower invested capital than is generally true or the worldwide group.

In our case, the California Franchise Tax Board used an arbi- rary basis because of our difficulty of rewriting reports from over 00 countries in which BAT's companies do business. This arbi- rary basis did not produce the correct tax, but satisfied the fran- nise tax board because it felt that in BAT's case, requiring a reater administrative burden would have resulted in even lower xes.

This experience reinforces our view regarding the resultant tax rtiality. If the law requires full combination of worldwide activi- es, then the franchise tax board acts unfairly toward BAT or her taxpayers, as the case may be, when it favors expediency er legal requirements.

If the use of the worldwide combined reporting system has rked to our financial benefit, why, then, do we support S. 1688, ich would return us to the threat of higher taxes in California? Because the use of the worldwide combined reporting system is totally unjust that we prefer the old basis of assessment, not- hstanding the additional tax burden. Combining worldwide and en unrelated lines of business does not take into account often quite different factors. California wages are significantly higher than the labor rates of most companies, which may vary widely, and as long as this disparity is present, the payroll factor of the three-factor formula will always report and will always produce distortions to the State's benefit.

If I may continue, Mr. Chairman, the currency rates can also cause distortion. California, for example, makes no allowance for the fact that some currencies are not practically convertible into U.S. equivalents, or that many countries, particularly those in the Third World, restrict or even bar transfer of funds.

California has gone so far as to include profits earned in countries which BAT cannot repatriate, even though the Federal Internal Revenue Service would have excluded them.

Distortion can also result due to the wide international variance of import duties and excise and sales taxes. Those taxes are included in the cost of sales which, when combined, can cause distortion due to their wide range.

Being part of a worldwide group of companies operating in differing and unrelated lines of business, we are concerned about proliferation of worldwide combined reporting system. Countries whose corporations are being abused by its use could develop retaliatory measures. Unscrupulous foreign government authorities could use the system to impose confiscatory taxation under the cloak of respectability.

The Federal Government has recently agreed in a tax treaty with the United Kingdom not to utilize the worldwide combined reporting system. Given that recognition of the need to limit the use of worldwide combined reporting system, S. 1688 should be enacted. It would eliminate the abuses of the current use of the system by a few individual States and prevent its proliferation.

It would provide consistency and uniformity in the taxation of international commerce, and spur investment and creation of employment opportunties in this country.

Mr. Chairman, I want to thank you again for having been invited, and I appreciate the opportunity.

Senator BYRD. Thank you, Mr. Kirk.

Does Brown & Williamson have a cigarette plant in California?

Mr. KIRK. No, sir, we do not.

Senator BYRD. What facility do you have there?

Mr. KIRK. We warehouse inventory there, and we have sales offices, and we do conduct business there, yes, but we have limited—one of the things we have limited in California is our assets. Yes, sir. But we do have warehouses and inventory and sales offices.

Senator BYRD. I assume that from the point of view of each of you that S. 1688 is as satisfactory as S. 983?

Mr. DOYLE. Mr. Chairman, they are not aimed exactly at the same topics, as you pointed out a number of times. S. 1688 is a narrower bill in scope.

Senator BYRD. Yes.

Mr. DOYLE. And the National Foreign Trade Council hasn't directed its comments to the broader bill.

Senator BYRD. You would prefer the broader bill?

Mr. Doyle. We would support it, but I don't think it is a substitute for 1688, nor is 1688 a substitute for the broader bill. We feel 1688 is a good step forward.

Senator Byrd. Thank you very much. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

National
Farmers Union

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NEWS RELEASE

For Immediate Release

FARMERS UNION CHARGES BILL BARRING "UNITARY" STATE TAX POLICY WOULD HURT U.S. FARMERS AND EXPORT JOBS AND IMPORT OTHERS' UNEMPLOYMENT

WASHINGTON, D.C., June 24, 1980 --- National Farmers Union today urged the Senate Finance Committee to reject a bill, S. 1688, which proposes to prohibit the states from using the "unitary apportionment method" of determining the taxable income of out-of-state or multinational corporations doing business within a state.

Reuben L. Johnson, director of legislative services for the National Farmers Union, said such legislation would run counter to recent Supreme Court decisions and be contradictory to recent Congressional actions.

Johnson noted that Congress is about to adopt legislation imposing capital gains taxes upon foreign investors when they re-sell U.S. property.

"It would be ironic for the Congress to impose the capital gains tax and then pass this bill which would prevent the states from taxing foreign source income of multinational firms," he said.

In March, the U.S. Supreme Court, in a case involving Mobil Oil Corp., and in June, in a case involving EXXON, upheld the use of the unitary apportionment method of determining corporate earnings attributable within a state, Johnson said.

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The Farmers Union official estimated that adoption of the bill, S. 1688, would affect tax systems in 30 states and potentially cause a loss of revenue of about $1 billion.

"The revenue loss most likely would cause a shift of the state tax burden to real estate, which in most areas is already heavily over-taxed," Johnson continued.

The Farmers Union testimony contended that the proposed legislation would have several harmful effects:

* It would subsidize foreign investment in U.S. farmland by sheltering profits of foreign investors from effective state taxation. "We don't need or want the foreign capital in our farmland," he said.

* It would encourage the restructuring of corporations so that the bulk of their American profits could be ascribed on paper for tax purposes to foreign subsidiaries or associates.

* It would further encourage investments by U.S. firms in foreign operations, which already in 1980 are estimated at $48 billion. "This has a negative effect of exporting jobs and importing unemployment," Johnson argued.

* It would be an unwarranted interference with the rights of the states to design and run their own state tax systems.

Johnson said that foreign investment in U.S. farmland is at alarming levels. "More than half of the farmland owned by aliens has been acquired since 1975," he pointed out.

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National
Farmers Union

STATEMENT OF

REUBEN L. JOHNSON
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

Presented to the

U.S. SENATE COMMITTEE ON FINANCE
Washington, D.C.

June 24, 1980

At the 78th annual convention of National Farmers Union, held March 2-6, 1980, at Denver, Colorado, our delegates adopted a statement directly related to this pending legislation. The statement, entitled "Taxation of Multinational Corporations," declared:

> "We oppose legislation which would prohibit states from using the 'unitary apportionment method' of determining the taxable income of multinational corporations doing business within the state. Such legislation would legalize tax breaks rejected by the United States Senate in defeating Article 9(4) of the United Kingdom Tax Treaty in 1978."

Farmers Union had vigorously opposed Article 9(4) in 1978 because it constituted a new and significant incentive to foreign investment in American farmland.

It will be recalled that Article 9(4) not only failed to win a required two-thirds majority, but did not even get approval of a majority of Senate members.

The 1978 United Kingdom Tax Treaty applied its ban on the use of the "unitary apportionment method" only to U.S. and U.K. corporations.

Tragically, this legislation would enlarge the tax loophole to make it available to multinational corporations of any origin or control.

The principal provision of S. 1688 would have the effect of prohibiting any state or locality from taxing foreign source income, which is not taxable under U.S. federal laws and regulations.

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This is undesirable on two grounds:

a. Current federal policy is very weak in relation to the definition and taxation of foreign source income.

b. It is an unwarranted interference with the rights of states to determine their income tax policy.

We are convinced that this legislation poses serious problems both for American agriculture and the national economy:

1. It would subsidize foreign investment in U.S. farmland by sheltering the profits of foreign investors from effective state taxation.
2. It would encourage the restructuring of corporations so that the bulk of their American profits could be attributed on paper to foreign associates or subsidiaries.
3. It would spur the flight of U.S. capital into foreign investments.
4. It would result in a substantial loss of revenue to state governments, on the magnitude of $1 billion a year, tending to shift the tax burden to the real property tax base, already heavily over-taxed.

The undesirable results would be the encouragement of the invasion of foreign capital into American agriculture --- something which in our view would be disruptive, undesirable and unneeded. In the national economy as a whole, the negative results would be the exporting of jobs and the importing of unemployment.

At about the same time that National Farmers Union was opposing ratification of the United Kingdom Tax Treaty with its Article 9(4) provision, our organization was also strongly urging Congress to approve and the President to sign the Agricultural Foreign Investment Disclosure Act of 1978 (AFIDA).

The first report under AFIDA was published in February, 1980, and annual reports are required hereafter by that law.

The data made available under AFIDA so far has been preliminary and partial. It does not closely correspond with other studies by the Commerce Department and the General Accounting Office. Apparently, because of concealment of ownership, we have only been able for the moment to see the tip of the iceberg.

But, it is already clear, as can be seen from ATTACHMENT I, that the recent foreign acquisitions have been on an alarming scale.

Fifty-four percent of all farmland parcels owned or controlled by aliens have been purchased in 1975 or since. More than three-fourths of the value of farmland owned by aliens has been acquired in 1975 or since.

We are not contending that all investment in foreign countries by American companies or all investments in this country by foreign countries should be stopped. But, U.S. policy must recognize the economic self-interest of the United States.

U.S. policies over the past two decades have tended to be unbalanced. They have tended to encourage investments in foreign rather than domestic activities.

In energy, for example, too much was invested in the Middle East and not enough in oil and gas exploration and development domestically.

Corporate decisions have diverted investment capital to multinational activities abroad at the expense of modernizing domestic plants. Thus, we now have aging plants and less competitive industries in steel, electronics and elsewhere.

At the worst, government policy should be neutral on foreign investment. But, if it is going to lean one way or another, it ought to lean in favor of domestic investment.

That the volume of investment by American firms in foreign subsidiaries and associates is still substantial is shown in ATTACHMENT II, a reprint of an article from the March, 1980, Survey of Current Business, entitiled "Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies."

This report indicates majority-owned foreign affiliates of U.S. companies plan a 26% increase in capital expenditures in 1980 and that the total for the year will be about $48.4 billions. This is a new record level, following upon a large increase in 1979.

Three-fourths of the capital expenditure will be in affiliates in developed countries.

Petroleum affiliates plan to increase capital expenditure by $15.4 billions, about two-thirds of it in developed countries.

Turning now to foreign investment in U.S. agriculture and industry, the U.S. Treasury Department, in a report submitted to the Congress under Section 553 of Public Law 95-500, acknowledged that "foreign persons rarely incur capital gains on the disposition of their U.S. property holdings." This is acknowledged in the transmittal letter from Secretary Blumenthal, accompanying the report, as shown in ATTACHMENT III.

The Treasury acknowledges that the "U.S. exemption for gain on real property not effectively connected with a U.S. trade or business is unusual by international standards."

The Treasury report notes that the model income tax treaty developed by the Organization for Economic Cooperation and Development (OECD) recognizes that gains derived by a resident of one state from the alienation of immovable property in another state may be taxed in the other state.

The Treasury Department calculates that in 1979, the revenue lost by failure to tax capital gains on property sold by foreign investors amounted to about $276 million.

Congress, in its wisdom, is now well along with consideration of legislation which would assure that foreign investors, who own U.S. property, would be subject, when they resell it, to capital gains taxation, the same as a domestic owner. Such a measure, in fact, has cleared this Committee just last week. It would be contradictory, in our view, for the Committee having voted to impose capital gains taxation upon foreign investors in U.S. farmland and other property, now to adopt S. 1688, limiting state powers to tax foreign source income.

Finally, it is important to recognize that the principle of the "unitary apportionment method" has been upheld by the highest court in our land in two recent decisions.

On March 19, 1980, in the case of Mobil Oil Corp. vs. the Commissioner of Taxes of Vermont, and on June 10, 1980, in the case of EXXON Corp. vs the Department of Revenue of Wisconsin, the U.S. Supreme Court has upheld the propriety of the unitary system.

It is worth noting that in both decisions, the high court rejected the contention that imposing taxes on foreign source income through use of the unitary method violated the due process clause or the commerce clause of the U.S. constitution, imposed a burden on commerce or subjected the corporation to multiple taxation.

Considering the thrust of these decisions, we conclude that it would be a step backwards for the Congress to approve S. 1688.

ATTACHMENT I

DATE OF ACQUISITION OF U. S. AGRICULTURAL LAND HELD BY FOREIGN OWNERS, 1979

DATE OF ACQUI-SITION	NUMBER OF PARCELS RE-PORTED	ACRES	NUMBER RE-PORTING PUR-CHASE PRICE*	PURCHASE PRICE (THOU $)	NUMBER RE-PORTING NON-PUR-CHASE PRICE*	NON PURCHASE PRICE (THOU $)	NUMBER RE-PORTING CURRENT VALUE*	CURRENT VALUE (THOU $)	NUMBER RE-PORTING EQUITY*	EQUITY (THOU $)
1979	82	32,700	76	$ 37,659	6	$ 4,997	79	$ 45,732	69	$ 25,184
1978	735	442,854	710	429,523	25	5,163	659	438,318	681	260,203
1977	429	444,529	416	274,300	13	1,830	377	226,978	385	191,691
1976	364	301,636	345	126,471	15	3,966	322	147,132	341	88,644
1975	233	153,626	221	74,327	12	2,221	206	68,986	222	44,995
1974-70	640	335,724	592	211,546	43	7,563	559	246,439	600	155,685
1969-60	636	784,239	596	72,892	28	1,184	544	168,781	576	64,314
Before 60	272	404,530	237	15,705	27	1,550	250	58,192	237	16,810
No report	1	160	1	72	0	0	0	0	1	21
TOTAL	3,392	2,899,998	3,194	$1,242,495	169	$ 28,474	2,996	$1,400,558	3,112	$ 847,547

* Number of Parcels for which information was reported.

Report, FOREIGN OWNERSHIP OF U.S. AGRICULTURAL LAN
USDA-ESCS, 1979

ATTACHMENT II

By WILLIAM K. CHUNG

Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies, 1980

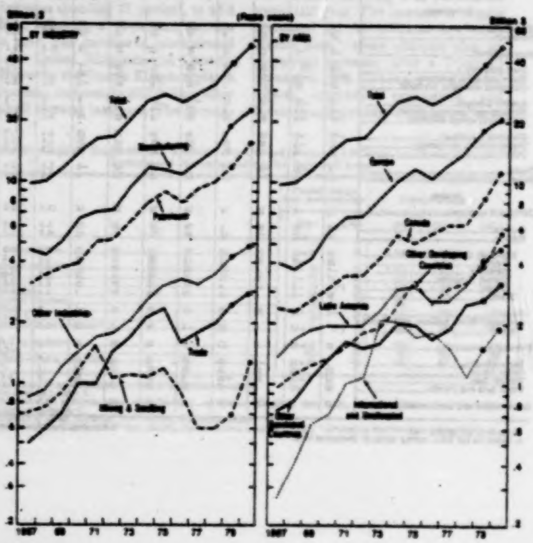
MAJORITY-owned foreign affiliates of U.S. companies plan a 28-percent increase in capital expenditures, to $48.4 billion, in 1980, about the same increase as in 1979 (chart 11 and table 1).[1] These increases exceed the previous record increase in actual expenditures of 23 percent in 1974. The 1980 increase reflects unusually large increases by affiliates manufacturing transportation equipment and by petroleum affiliates. It is planned despite expectations of an economic slowdown in major host countries, and partly reflects continued high rates of inflation abroad. Capital expenditures are reported to BEA in current dollars; they are not adjusted for price changes in host countries, because the data needed for such adjustments are unavailable.

By area, affiliates in developed countries plan to increase spending 25 percent, to $36 billion, about the same rate of increase as in 1979 (table 2). In developing countries, affiliates plan a 30-percent increase in spending, to $10.4 billion, following a 28-percent increase. Affiliates in "international and unallocated"—mainly those with shipping operations spanning more than one geographic area—plan a 25-percent increase, to $1.9 billion, following a 33-percent increase.

By industry, manufacturing affiliates plan a 25-percent increase, to $23.9 billion, compared with a 31-percent in-

CHART 11

Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies



● Planned

U.S. Department of Commerce, Bureau of Economic Analysis

NOTE.—The estimates were prepared by Jeffrey H. Lowe.

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1. Capital expenditures are expenditures that are made to acquire, add to, or improve property, plant, and equipment, and that are charged to capital accounts. They are on a gross basis; sales and other dispositions of fixed assets are not netted against them.

2. A majority-owned foreign affiliate is a foreign business enterprise in which a U.S. company owns, directly or indirectly, at least 50 percent of the voting rights. These data are universe estimates based on BEA's semiannual sample survey. The latest survey, taken in December 1979, covered about [illegible] majority-owned foreign affiliates.

crease in 1979. Petroleum affiliates plan to increase spending 29 percent, to $15.4 billion, following a 19-percent increase. In other industries, a 23-percent increase, to $9 billion, is planned, following a 21-percent increase.

For all areas and industries combined, latest plans for 1980, reported in December 1979, were revised upward from plans reported last June, which showed a 15-percent increase. The sharp upward revision was widespread by area, but, by industry, was concentrated in petroleum and transportation equipment manufacturing. The revision in petroleum partly reflects the fact that in the earlier survey, a number of large U.S. petroleum companies were unable, as in the past, to provide reliable estimates so far in advance.

Latest plans for 1979 were also revised upward from earlier plans, but by a much smaller amount. The largest revisions were in petroleum and manufacturing, particularly nonelectrical machinery and chemicals and allied products.

Manufacturing

Manufacturing affiliates plan to increase spending 25 percent in 1980, to $33.9 billion, following a 31-percent increase in 1979. Two industries—transportation equipment and paper and allied products—account for more than two-thirds of this year's increase. Affiliates in transportation equipment plan a 61-percent increase, only a few percentage points less than last year's increase (table 3). If current plans are met, spending by these affiliates will have nearly tripled since 1978, to $6.1 billion. In paper and allied products, a near-doubling of spending to $2 billion is planned this year. Affiliates in all other manufacturing industries combined plan a moderate increase—11 percent, compared with 25 percent last year (table 4).

The massive capital spending program in the transportation equipment industry is primarily for development of an international network to produce components for fuel-efficient automobiles, known as "world cars." The "world cars" share a basic design and have standardized components, which can be manufactured in large volume at several specialized plants and then assembled into final products near major consumer markets. Development of these fuel-efficient models is one response of U.S. automakers to the continued rise in petroleum prices. By standardizing components, the auto-

Table 1.—Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies, 1974-80

	Percent change from preceding year								Billions of dollars								
	Actual expenditures				Latest plans[1]		Earlier plans[2]		Actual expenditures					Latest plans[1]		Earlier plans[2]	
	1975	1976	1977	1978	1979	1980	1979	1980	1974	1975	1976	1977	1978	1979	1980	1979	1980
Total	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
By industry																	
Mining and smelting	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Petroleum	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Manufacturing	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Food products	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Paper and allied products	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Chemicals and allied products	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Rubber products	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Primary and fabricated metals	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Machinery, except electrical	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Electrical machinery	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Transportation equipment	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Trade	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
By area																	
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Canada	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Europe	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
European Communities (9)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
France	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Germany	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
United Kingdom	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Japan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Australia, New Zealand and South Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin America	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Middle East	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Asia and Pacific	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

*Less than 0.5 percent (±).

1. Based on the BEA survey taken in December 1979.

2. Based on the BEA survey taken in June 1979.

makers also expect to achieve economies of scale that will enable them to compete more effectively in international markets.

As shown in table 3, the large spending increases in transportation equipment manufacturing are in Europe, Canada, and Mexico. These increases are mostly for the construction of new plants and the expansion of existing facilities to assemble and to produce engines and other components for the "world cars." Affiliates in Austria (included in "other" Europe in table 3) plan to build plants to manufacture engines and other components, while those in Spain and France plan to build several components plants. Major expansion and modernization of existing production facilities are underway in Germany, the United Kingdom, and Canada. In Mexico, affiliates plan to build an assembly plant and several components plants. Mexican affiliates' spending plans have been encouraged by a government policy, announced in 1977 and to go into effect in 1982, that will limit the value of imports by Mexican auto producers to no more than the value of products they export. In Mexico, as in several other developing countries, affiliates primarily assemble automotive products from imported components. The new plants will manufacture engines and other components to reduce such imports.

In paper and allied products, affiliates plan a 93-percent increase this year, to $2 billion, following a 22-percent increase in 1979. The increase is centered in Canada (tables 5A–C) and is for the construction of new plants and expansion of existing production facilities. It is in response to strong demand for paper and allied products in North America, where production capacity has not kept pace with the growth in consumption in the last few years.

Affiliates in manufacturing industries other than transportation equipment and paper and allied products plan to increase spending 11 percent, to $15.9 billion, following a 25-percent increase. Smaller increases are expected in most major areas, particularly in Canada and the United Kingdom, and in most industries, particularly in chemicals. They reflect the anticipation of economic slowdowns in most major host countries.

Table 2.—Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies, Selected Areas and Industries, Latest Plans for 1979 and 1980

	1979				1980			
	Total	Petroleum	Manufacturing	Other ¹	Total	Petroleum	Manufacturing	Other ¹
	Percent change from preceding year							
All areas	[illegible]	19	[illegible]	[illegible]	[illegible]	29	[illegible]	[illegible]
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International and unallocated	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]		[illegible]
	Billions of dollars							
All areas	35.8	12.0	16.5	7.2	46.4	15.4	22.1	8.9
Developed countries	28.9	7.8	16.4	4.7	36.0	9.6	20.7	4.7
Developing countries	6.1	3.6	2.0	1.7	10.4	4.9	3.3	2.2
International and unallocated	1.2	.6		.9	1.9	.9		1.0

1. Consists of mining and smelting, trade, and "other" industries, which are shown separately in table 1.

Petroleum

Petroleum affiliates plan to increase spending 29 percent, to $15.4 billion, following a 19-percent increase last year. The step-up mainly reflects intensified exploration for and production of petroleum in the wake of a near-doubling of crude oil prices during 1979 by members of the Organization of Petroleum Exporting Countries.

In developed countries, affiliates plan to increase spending 23 percent, to $9.6 billion, following a 15-percent increase last year. The increase is concentrated in the United Kingdom and Canada. Affiliates in the United Kingdom plan a 33-percent increase, to $3.7 billion, after a small increase last year. The increase reflects the acceleration of exploration and production in the North Sea area and modernization of refinery facilities and gas stations. Canadian affiliates plan a 26-percent increase, to $3.4 billion, following a 34-percent increase. The increase is largely for the continued development of tar sands projects, exploration and development of new fields, and expansion of refinery facilities.

In developing countries, affiliates plan to increase spending 38 percent, to $4.9 billion, following a 21-percent increase last year. The increase is largely accounted for by affiliates in "other Middle East"; these affiliates plan an 88-percent increase, after a 7-percent increase in 1979. The sharp acceleration reflects intensified exploration and development activity, expansion of pro-

Table 3.—Capital Expenditures by Majority-Owned Foreign Affiliates in Transportation Equipment Manufacturing, by Selected Areas

	Percent change from preceding year		Millions of dollars		
	1979 ¹	1980 ¹	1978	1979 ¹	1980 ¹
All countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Canada	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Europe	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Germany	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
United Kingdom	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Spain	[illegible]	[illegible]	[illegible]	(D)	(D)
Other ²	[illegible]	[illegible]	[illegible]	(D)	(D)
Other developed countries ³	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Mexico	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other developing countries ⁴	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

D Suppressed to avoid disclosure of data of individual reporters.
1. See footnote 1, table 1.
2. Consists of all countries, other than Germany, the United Kingdom, and Spain, that are shown separately under "Europe" in tables 5A–C.
3. Consists of Japan, Australia, New Zealand, and South Africa.
4. Consists of all countries, other than Mexico, that are shown separately under "developing countries" in tables 5A–C.

duction and refinery facilities, construction of additional port facilities, and a saltwater injection system to assist in more complete extraction of petroleum.

In "international and unallocated," spending is expected to increase 48 percent, to $0.9 billion, after doubling in 1979. The increase is for the expansion of tanker fleets in response to a strong recovery in tanker rates.

Trade, mining and smelting, and other industries

Trade affiliates plan an 13-percent increase, to $2.0 billion, following a 22-percent increase last year. Increases are planned in both developed and developing countries. Among developed countries, the increase is widely dispersed, particularly in Europe, and is partly for office building modernization and expansion of warehouse capacity. In developing countries, the increase is centered in Brazil, where affiliates plan to modernize warehouse facilities.

Mining and smelting affiliates plan to increase spending to $1.3 billion, up 30 percent, following a 28-percent increase last year. The increase is concentrated in Canada—mainly for the construction of new copper smelting facilities—and in Australia—for the construction of new bauxite smelting plants and mine expansion. Indonesian affiliates also plan a sizable increase, primarily for the development of new copper mines.

Affiliates in "other" industries—agriculture, public utilities, transportation, construction, and finance and other services—plan a 15-percent increase, to $4.8 billion, following a 19-percent increase. Large increases are planned for the construction of a new power station in Hong Kong and for the construction of bulk ore vessels by affiliates in "international and unallocated."

Table 4.—Capital Expenditures by Majority-Owned Foreign Affiliates in Manufacturing Industries Other Than Transportation Equipment and Paper and Allied Products, by Selected Areas

	Percent change from preceding year		Millions of dollars		
	1979¹	1980¹	1978	1979¹	1980¹
All areas	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Canada	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Europe	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
European Communities (9)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
France	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Germany	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
United Kingdom	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Japan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Australia, New Zealand, and South Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin America	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Middle East	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Asia and Pacific	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

1. See footnote 1, table 2.

Table 54.—Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies in 1978[1]

(Millions of dollars)

	All industries	Mining	Petroleum	Manufacturing: Total	Food products	Paper and allied products	Chemicals and allied products	Rubber products	Primary and fabricated metals	Machinery, except electrical	Electrical machinery	Transportation equipment	Other manufacturing	Trade	Other industries
All countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Canada	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Europe	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
European Communities (9)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Belgium and Luxembourg	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
United Kingdom	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Japan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Australia, New Zealand and South Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Australia	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
New Zealand	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
South Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin America	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin American Republics	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Central America	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Western Hemisphere	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Middle East	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Iran	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Asia and Pacific	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

* Less than $500,000.

D Suppressed to avoid disclosure of data of individual reporters.

1. See footnote 1, table 1.

Table 5B.—Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies in 1979 [1]

(Millions of dollars)

Manufacturing

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*Less than $500,000.

D Suppressed to avoid disclosure of data of individual reporters.

[1] See footnote 1, table 1.

Table 8C.—Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies in 1980[1]

[Millions of dollars]

	All industries	Mining	Petroleum	Manufacturing: Total	Food products	Paper and allied products	Chemicals and allied products	Rubber products	Primary and fabricated metals	Machinery, except electrical	Electrical machinery	Transportation equipment	Other manufacturing	Trade	Other industries
All countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developed countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Canada	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Europe	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
European Communities (9)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Belgium and Luxembourg	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
United Kingdom	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Japan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Australia, New Zealand and South Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Developing countries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin America	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Latin American Republics	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Western Hemisphere	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Africa	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Middle East	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other Asia and Pacific	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International and unallocated	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

* Less than $500,000.

D Suppressed to avoid disclosure of data of individual reporters.

1. See footnote 1, table 1.

ATTACHMENT III

Taxation of Foreign Investment in U.S. Real Estate

THE SECRETARY OF THE TREASURY
WASHINGTON

MAY 4 1979

Dear Mr. Chairman:

Section 553 of Public Law No. 95-500, the "Revenue Act of 1978," required the Treasury Department to conduct a study and analysis of the appropriate tax treatment of income from, or gain on the sale of, interest in United States property held by nonresident aliens and foreign corporations. The Secretary is required to transmit a report of the results of this study, together with the recommendations of the Department, within six months of the date of enactment of the Act.

Pursuant to these provisions, I hereby submit a report entitled "Taxation of Foreign Investment in U.S. Real Estate."

Under present law, capital gains realized by nonresident aliens and foreign corporations are not subject to U.S. tax unless they are "effectively connected" with a U.S. trade or business. The Treasury Report finds that, while most real property holdings of foreign persons is used in a U.S. trade or business, foreign persons rarely incur capital gains tax on the disposition of their U.S. property holdings. The Report identifies various ways in which the capital gains on real estate, which would ordinarily be taxable, can be converted into capital gain on some other asset, which would not. The principal means by which this is accomplished is through a real property holding company, and converting gain realized on disposition on the "effectively connected" property into gain realized on disposition of the shares, which is not deemed "effectively connected."

The Treasury does not believe that taxing capital gain on the sale of corporate shares is desirable or practical. But to prevent unintended tax avoidance, the Treasury recommends modifying certain specific statutory provisions under which foreign taxpayers convert taxable gain on real estate into nontaxable gain. The Report describes certain steps which may be taken in this regard. The Treasury plans to work with the Congress and with other agencies of the Government in developing formal legislative proposals in this area.

I am sending an identical letter to Senator Russell B. Long, Chairman of the Committee on Finance.

Yours very truly,

WMBlumenthal

W. Michael Blumenthal

The Honorable
Al Ullman, Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Enclosure

TESTIMONY

OF

MR. ROBERT L. McNEILL

EXECUTIVE VICE CHAIRMAN

EMERGENCY COMMITTEE FOR AMERICAN TRADE

SUMMARY

The Emergency Committee for American Trade strongly supports S. 1688 which embodies a very simple but important principle fundamental to the conduct of the international commerce of the United States; namely, that the individual states of the United States should not design their tax laws to impose undesirable extraterritorial tax burdens on international business activities. This principle should apply equally to U.S. or foreign based enterprises. We further believe that individual states should limit their income tax jurisdiction to the jurisdictional reach of the Federal income tax laws.

The underlying factors that can make a unitary system work internally are not present internationally. There are no agreed-upon international standards for determining the relevant apportionment factors and their relative weight.

The economic and accounting factors of wages, assets, and income are too diverse internationally to permit accurate weighting among foreign countries.

S. 1688 sensibly introduces a rule of conformity so that to the extent states tax foreign source dividend income, they may do so only insofar as such income is effectively taxed by the United States under the Internal Revenue Code.

TESTIMONY OF MR. ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE SENATE COMMITTEE ON FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON S. 1688

June 24, 1980

I am Robert L. McNeill, Executive Vice Chairman of the Emergency Committee for American Trade (ECAT), and am pleased to be here today to testify in support of S. 1688. ECAT is an organization of 64 U. S. companies with extensive international business operations. In 1979, worldwide sales by these companies totalled about $450 billion and they employed 5 million people.

We support S. 1688 because it embodies a very simple but important principle fundamental to the conduct of the international commerce of the United States; namely, that the individual states of the United States should not design their tax laws to impose undesirable extraterritorial tax burdens on international business activities. This principle should apply equally to U.S. or foreign based enterprises. We further believe that individual states should limit their income tax jurisdiction to the jurisdictional reach of the Federal income tax laws.

As contemplated by the framers of our Constitution, the United States should act with one voice, the Federal voice, in matters of international commerce.

Let me be certain at the outset that there is an accurate perspective concerning the scope of S.1688, which is designed to conform the limits of state tax jurisdiction to the Federal limits.

First, the proposed legislative limitation on worldwide combination methods of taxation -- which take into account the income of all foreign affiliates of corporations doing business within a state, even though such income has no connection with the state -- will not affect the ability of states to assess tax allocations on a unitary basis for the income of those companies actually doing business within the states. Further, the proposed limitation does not represent an attack upon allocation formulas currently applied by the states to those entities.

Second, the proposed limitation upon worldwide combination does not deal with any long-standing, traditional, or widespread practice of state taxation. Indeed, it would affect only a handful of states in any manner and then only as to practices adopted very recently by them.

The proposed limitation does not necessarily hurt all business or aid all tax administrators. The unitary rules in some instances can benefit taxpayers.

We support the limitation on the use of worldwide combination rules internationally, however, because in that context it is an unsound rule and leads to increasingly undesirable consequences.

To be specific: --

- Whatever utility and justification there is for the use of income allocation formulas applied to a single corporate entity operating within two or more of the separate states of the United States, the underlying factors that can make such a system work internally are not present internationally;

- There are no agreed upon international standards for such a system in determining the relevant apportionment factors and their relative weight, or standards to define the businesses to be included as unitary, or the income to which such rules are to be applied;

- The economic and accounting factors of wages, assets, and income are too diverse internationally to permit accurate weighting among foreign countries. Wages, assets, turnover, and the currency used, all have some comparability when applied among and confined to the states of the United States. They do not have such comparability as applied among Botswana, the United States, Ireland, and more than 100 other countries.

ECAT has a primary interest in encouraging maximum growth of United States trade and in eliminating barriers to international investment and to the export of U. S. goods. We are concerned that if the use of worldwide combination methods with respect to international income were to spread to developing nations, it would create a serious threat to international trade. Each country would develop its own weighting formulas and would use administrative procedures designed to secure all possible income from the worldwide operations of all related companies.

In contrast to the worldwide combination method, progress has been made in securing a degree of international conformity in the taxation of foreign income. There has been widespread acceptance of the principle that tax jurisdiction is exercised only where there is actual physical presence or economic activity by a foreign company within a country. There is further agreement that where transactions occur between related companies, including those that are outside the taxing jurisdiction, the rule to be uniformly applied is that all export and other inter-company transactions must be conducted at arm's length on a separate accounting basis. This is the tax basis found in our Internal Revenue Code and in the laws of Germany, Canada, Japan, France and all of the other developed countries. It is the basis of taxation embodied in the 1977 OECD Model Income Tax Convention. It is also embodied in a recently completed Model Income Tax Convention for Treaties between Developed and Developing Countries.

Those handful of states attempting to introduce a different and inappropriate method of taxation -- the worldwide combination method which takes into account the income of foreign corporations that are not engaged in business in the United States -- are clearly out of step with United States and international practice.

We believe that the worldwide combination practice of a few American states presents an especially burdensome requirement for foreign corporations that have no independent reason to compile or maintain records conforming to U. S. tax accounting standards. The administrative burden, coupled with the demonstrated extraterritorial reach of the tax assessed, has two important practical consequences. The first is that because foreign governments resent the worldwide combination method of apportionment, they are unwilling to provide favorable tax treatment for American business. Department of Treasury representatives have found that the worldwide combination method as practiced in the few states is a significant adverse burden in United States international tax treaty negotiations.

Another important related factor is that the worldwide combination method is a deterrent to the type of foreign investment the United States would presumably benefit from the most; namely, manufacturing investment by major foreign multinationals who today must weigh the consequences of their entire worldwide structure when making investment decisions. Their structure involves perhaps dozens or even hundreds of foreign affiliates that conduct no business in the United States. Thus, a decision to invest in the United States could, under the worldwide combination method, create the risk of the income of those affiliates being taxed by a single state of the United States. Obviously, foreign companies have some freedom of choice in avoiding states advocating such methods of taxation. Recognition of this fact appears to have had some impact in California where the California assembly with the Governor's support has passed a bill that would exempt foreign based multinationals operating in California from the burden of combined reporting with their foreign affiliates.

Such piecemeal approaches to correcting a national issue reinforces the argument for Federal legislation.

We think the worldwide combination system is wrong as applied to foreign based companies and we think it is wrong as applied to United States based companies. This issue was the subject of considered review by the Foreign Income Task Force of the Ways and Means Committee under Congressman Rostenkowski, and we concur with the conclusions of the Task Force which are now embodied in S. 1688.

S.1688 also addresses a second unjustified burden of state taxation of foreign income that was described in the Task Force Report, which observed that the lack of uniform rules among the states leads to inappropriate state taxation of dividends from foreign subsidiaries. Earlier this month the Supreme Court observed that the Congress can act to provide a rational system of state taxation of foreign source dividends. S. 1688 sensibly introduces a rule of conformity so that to the extent states tax foreign source dividend income, they may do so only to the extent such income is effectively taxed by the United States under the Internal Revenue Code.

When one cuts through all of their rhetoric, the best case made by those state tax administrators who have sought to export the worldwide combination method is the argument that it is a better method. I know of no better reply to this than the observations of Alan R. Short, Director of the Tax Policy Branch of the Canadian Department of Finance at Fordham University in 1976:

> "I am going to play devil's advocate, a role I enjoy, and start off with the position that I feel badly that the unitary system has had such rough treatment. Therefore, I would like to find some way to defend and support it. I would like to give it a conditional blessing with several 'ifs.' If the tax system of all countries in the world were identical, if the tax accounting practices did not differ, if everybody could agree on the principles of amalgamation, if everybody could agree as to what a unitary business was, if it was not necessary to determine the nature or quality of the income for tax purposes (whether it was a manufacturing resource profit, an export profit, a royalty), if countries could agree on exactly the same formula for allocating income, if the price of labor and the cost of capital were identical in all countries, if we had a single monetary unit in the world, if there were no minority interests in any subsidiary companies within a group, if the existing scheme did not work, and if the unitary system was not inestimably arbitrary, I would support it."

STATEMENT OF THE
NATIONAL FOREIGN TRADE COUNCIL, INC.
ON S. 1688 AND S. 983
BEFORE THE SENATE FINANCE COMMITTEE

JUNE 24, 1980

NFTC

National Foreign Trade Council Inc.
10 Rockefeller Plaza
New York, NY 10020
212-581-6420

My name is Albert Doyle. I am Senior Tax Attorney with Texaco Inc. and Chairman of the Tax Committee of the National Foreign Trade Council, Inc., a non-profit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment. I am appearing on behalf of the National Foreign Trade Council today. I welcome this opportunity to comment on S. 1688 and S. 983.

Introduction

The two bills before the Subcommittee, although different in scope, address an issue which has been before the Congress since the enactment of Public Law 86-272 in 1959 and which the Supreme Court of the United States has on several occasions referred to the Congress for legislative consideration.

S. 983, the Interstate Taxation Act, is an omnibus bill which, if enacted, would solve many issues inherent in state taxation of interstate and foreign commerce. In addition to provisions concerning sales and use and gross receipts taxes, major income tax provisions of S. 983 would establish the circumstances in which a state could subject income to taxation, a method of apportionment of such income among several states, the extent to which foreign source income would be subject to state taxation and would provide for a system of judicial review of state tax disputes by a federal court. S. 983 is similar, but not identical, to many interstate taxation bills which have been introduced continually in every Congress since 1965.

The second bill, S. 1688, is a more narrow measure which would clarify the extent to which a state, or political subdivision, may tax certain income from sources outside the United States.

State Taxation of Foreign Source Income

Although the NFTC recognizes the need for federal legislation in regard to the many issues involved in state taxation of interstate and foreign commerce and supports the enactment of S. 983, because of the specific interest of the Council in foreign trade and investment, this statement will focus upon the more narrow issue of state taxation of foreign source income as covered in S. 1688.

In urging passage of S. 1688, we feel it would be useful to define the parameters of the proposed legislation - what it would do and what it would not do. The first part of the bill would prohibit states from taking into account, through the application of the unitary method of taxation on a worldwide combination basis, the foreign source income of foreign affiliates of a parent corporation doing business within the states unless and until the income is subject to Federal income tax. The bill applies whether the parent is a domestic or a foreign corporation. The states could include in income of the parent corporation any income of the foreign corporation which would be includible in the parent corporation's income for Federal income tax purposes. In effect, the legislation would limit the jurisdictional reach of the states in income taxation to that of the Federal Government. Similarly, the second part of the bill would conform state taxation of dividends received by a domestic corporation from a foreign corporation to dividend income that is effectively taxed by the Federal Government.

The proposed legislation would not be removing a long-standing or prevelant method of state taxation since use of the unitary method on a worldwide combination basis is a relatively recent phenomenon employed only by a few states, most notably California. Furthermore, this would not affect the unitary method of taxation employed by states that includes the income from domestic operations, but does not include the income from operations of foreign affiliates in the combination.

Worldwide Combined Reporting

First let's explore the nature and effect of one of the inequities this legislation seeks to cure: The taxation of foreign source income through worldwide combined reporting. Negative effects from this system are experienced both by U.S. corporations doing business abroad through foreign subsidiaries and by foreign parent companies of affiliates doing business in the U.S. It actually permits states that practice it to tax income on a broader basis than does the Federal Government. Income of foreign affiliates is taxed by the state immediately when earned, whereas such income is not subject to Federal tax until it is repatriated in the form of dividends.

An important consequence of the use of worldwide combined reporting by the states is its impact on foreign trade and commerce. As currently practiced by some states, this combined reporting method may be a significant deterrent to foreign investment in the U.S. Uncertainty as to how they will be taxed by the states undoubtedly is a factor preventing more foreign multinational corporations from doing business in the U.S. Removing this barrier would encourage greater foreign investment in this country, thereby creating jobs and improving our balance of payments. Furthermore, many United States trading partners are most unhappy with the worldwide combined system of reporting, to the point where trade between the United States and certain of these countries (especially the common market countries) may be adversely affected if no corrective action is taken. This problem has never been more clearly in focus than during the protracted negotiations involving the U.S.-U.K. income tax treaty. Article 9(4) of that treaty originally prohibited the application of the worldwide combination method of reporting income to U.K. companies whose subsidiaries were doing business in a state. However, a Senate reservation to the Treaty limited this prohibition to Federal taxes, leaving the document silent on the state taxation question. The displeasure of U.K. corporations and the British Government at this outcome could hardly be overstated. A press release issued just after the exchange of the instruments of ratification read in part, "Her Majesty's Government is...gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation... This is not only a setback for British corporate investment in the United States, it may also be inter-

Unfortunately, a reading of the March 31 testimony indicates that the question of the need for federal legislation to limit state taxation of foreign source dividends (the quantity or portion of income which is taxed) was not as adequately covered as was the need to prohibit the assertion of the unitary business concept.

Taxation of Foreign Source Dividends

The second part of the bill would provide an exemption from state taxation for dividends received by U.S. corporations from their foreign subsidiaries to the extent that the foreign taxes paid with respect to those dividends equal or exceed the 46 percent, a proportionate amount of the dividends would be exempt from state income tax. This mechanism would eliminate the unfair double taxation of income earned by foreign subsidies of U.S. corporations by permitting the states to tax only that portion of the foreign source dividends taxed by the Federal Government.

It has been said by critics of this portion of the bill that exempting dividends received by U.S. corporations from their foreign subsidiaries might unintentionally favor foreign over U.S. investment by eliminating the state level of taxation from these dividends and thus give tax preference to foreign versus domestic investment. However, it is our experience that in the hierarchy of reasons why U.S. companies do business abroad, state income tax consequences usually rank quite low, if they can be ranked at all. U.S. based corporations conduct business overseas in order to take advantage of opportunities not available in domestic markets. We can hardly

envision our companies rushing to incorporate abroad simply because some or all of the dividends they receive from their foreign subsidiaries will be exempt from state taxation in the U.S. Moreover, U.S. companies engaged in foreign commerce generally pay some form of local taxes to the host country in addition to national taxes. Thus, reducing or eliminating state income tax on dividends from foreign subsidiaries may only make the foreign operation a break-even proposition from this perspective.

The fundamental fact is that foreign dividends are actually subject to discriminatory taxation by the states. The dividends received deduction applies to domestic dividends includible in the Federal income base taxed by the states but does not apply to foreign dividends. The reason for this at the Federal level is the allowance of a foreign tax credit for taxes paid on the foreign source income from which the foreign dividends are paid.

However, under worldwide combined reporting, no credit is allowed by the states for foreign income taxes paid and so the protection against double taxation afforded by the foreign tax credit provisions of the U.S. tax law is not available for state tax purposes. This discrimination is exacerbated by the fact that the states do not adjust the factors of the apportionment formula which is applied to the foreign dividends to account for the property, payroll, and sales of the foreign affiliates which produced the income from which the dividends were paid; nor is that a desirable alternative, since the factors do not provide comparability when applied to different economies.

Enactment of limiting legislation in regard to the time (ie, prohibition of unitary taxation) at which states may tax the foreign source income of foreign affiliates will do little, if anything, to remove the burden of state income taxation of foreign commerce unless corollary legislation is enacted to limit the extent (ie, taxation of foreign source dividends) to which states can tax such income.

Fundamental to the question of the extent to which a state may tax income from sources outside the United States is an understanding of the basic difference between the power of the Federal Government to tax the worldwide income of its citizens and the much more narrowly-drawn power of the states. Unlike the power of the U.S. government to tax the worldwide income of its citizens, many U.S. Supreme Court cases have posed the question of whether there is a definite link between a state and the taxpayer's activity in the state. This link results from the state having provided services in return for which it can expect to receive remuneration under its taxing authority. States, therefore, are not (or should not be) permitted to tax true foreign source income simply on the basis of citizenship or residence.

Since the U.S. Government has the power to tax the worldwide income of its citizens, the foreign tax credit provisions of the Internal Revenue Code are structured to:

1) Prevent any diminution of U.S. tax on U.S. source income; and,
2) Permit the U.S. to tax foreign source income which has not been taxed by the host country.

Conversely, since the states are limited to taxing income only when there is a definite link between the state and the activity to be taxed, true foreign source income is not exposed to state taxation; and, therefore, foreign tax credit provisions are not necessary for state income tax purposes. In practice, with the exception of Alaska, foreign tax credit provisions are not included in state income tax laws.

Given these principles and absent any linkage between a state and a dividend-paying foreign affiliate, if dividends from such an affiliate are exposed to state income taxation without the benefit of a foreign tax credit, the income is taxed twice - first by the host country and again by the state.

The dividend provisions of H.R. 1688, then, provide a mechanism which is a substitute for the foreign tax credit provisions of the Internal Revenue Code. The result is to permit the states, like the Federal Government, to tax only that foreign source income which has not been taxed by the host country.

We previously quoted from a document indicating that the British Government was most anxious to have the U.S. give legislative attention to the solution of the problem of unitary worldwide taxation by the states and its negative impact on international commerce. We believe that foreign governments have the right to expect this. The Supreme Court of the United States, in the case of Japan Lines Ltd. vs. Country of Los Angeles, 60 L. Ed. 2nd 336 (1979), stated that the Federal Government must speak with one voice when regulating commercial relations with foreign governments. The court stated, at 347:

> "...a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern."

Tangible evidence of the difficulties encountered when federal uniformity is not maintained was presented when the U.S.-U.K. Treaty was significantly delayed as a result of the Article 9(4) controversy. And even though that treaty has finally become effective, its survival and continued vitality may depend upon whether Congress enacts legislation to correct the inequities caused by the state use of the unitary worldwide combination system of reporting. Clearly, too, a lack of action would have ramifications far beyond U.S.-U.K. economic relations, impacting on trade between the U.S. and many of its other trading partners.

Conclusion

Although it is obvious that a total resolution of the many issues of state taxation of interstate and international business will not be attained unless legislation similar to S. 983 is enacted by Congress, enactment of S. 1688 could provide a helpful first step toward a resolution of the overall problem.

Relief from the burden of double taxation of foreign source income has been sought by contesting the issue in the courts. Not only has no relief been forthcoming from the judiciary, but the courts have consistently stated that it is the responsibility of the Congress to provide a legislative remedy under its constitutional powers.

Congress has the power to take action in this matter and the need for the legislation is clear. We urge the Committee to report favorably on S. 1688 as an important first step toward the ultimate resolution of the entire interstate problem.

SONY

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Sadami (Chris) Wada
Assistant Vice President
Assistant to Chairman for Special Assignment

STATEMENT OF SADAMI (CHRIS) WADA
ASSISTANT VICE PRESIDENT
SONY CORPORATION OF AMERICA

on S.1688

Before the

COMMITTEE OF FINANCE
UNITED STATES SENATE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT

June 24, 1980

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Attachment--California State Bill AB-525

Summary of Statement of Sadami (Chris) Wada, Ass't V.P., Sony Corporation of America, on S.1688 Before the Senate Finance Committee, Subcommittee on Taxation and Debt Management, June 24, 1980

Sony has two major capital investments in the United States, which are $50 million capital investment in California with 1,600 local employees and $75 million capital investment in Alabama with 1,200 local employees. Economic contribution is significant to local communities and to the trade balance of the United States by minimizing import and maximizing U.S. exports.

In spite of our good efforts, California imposes upon us international double taxation through its unitary tax on a worldwide basis. Sony is penalized for one of its major capital investments in California. The unitary formula on a worldwide basis has many fundamental difficulties when applied on a worldwide basis. It creates distortions when its application is forced ignoring many international differences in accounting methods, management practices, national economics, risks, and flucturation of exchange rates. The "arm's length" test is the only fair and workable method, and is the one that is accepted not only by the Federal Government of the United States but also by nations in the world.

Unitary tax on a worldwide basis is against the urging of Japanese capital investment to manufacture in the United States. It threatens such desired activities. Even the California State Legislature acknowledges the problem and is in the process of making the correction by AB-525.

Sony strongly supports the passage of S.1688.

Statement of Sadami (Chris) Wada, Ass't V.P., Sony Corporation of America, on S. 1688 Before the Senate Finance Committee, Subcommittee on Taxation and Debt Management, June 24, 1980

Mr. Chairman and members of the Finance Subcommittee, my name is Sadami (Chris) Wada, and I am Assistant Vice President of Sony Corporation of America. Sony appreciates this opportunity to submit our statement in support of Senate Bill S.1688.

Sony Corporation of America is today being penalized in a unfair manner by the unitary tax on a worldwide basis in California. When the United States is urging Japan to make capital investments in the United States, the unitary tax on a worldwide basis works against such urging, desire and the widsom of the United States by penalizing Sony and others as well as by posing a threat to new or additional investments. S.1688 will bring an end to this bad tax system and will do the justice needed.

1. Sony Has Two Major Manufacturing Operations in the U.S.

Sony Corporation of America has two major capital investments in manufacturing in the United States. We manufacture color televisions in San Diego, California with local employment of over 1,600. In Dothan, Alabama, we manufacture video and audio magnetic recording tapes in cassettes. Investments are $50 million and $75 million respectively.

We have no tax problem with Alabama, but California uses the unitary tax on a worldwide basis and we are strongly opposing it.

Particularly, in this regard, we would strongly support Senate Bill S.1688 and earnestly wish for the passage of the bill.

2. Sony San Diego Color Television Factory

Since 1972, Sony has been manufacturing color televisions in San Diego; and today, we employ 1,600 people, of which only about three percent are Japanese. Our total capital investment in land, buildings, and manufacturing machines amounts to $50 million. Our current annual payroll alone is almost $20 million. If all payrolls-to-date are added, the total will be several tens of millions of dollars. Our employees use their income to pay taxes, to purchase appliances, homes, automobiles, education, vacation and other daily needs. Our plant purchases utilities, all kinds of services in addition to parts, supplies, and other materials. All of these make a significant economic contribution to California. This is also certainly true with our magnetic tape plant in Alabama.

3. Sony San Diego Exports Color Televisions

Further economic contribution is being made by increased production and export to overseas. I expect Sony San Diego will export California-made color televisions almost $50 million this year. The State of California needs job opportunities and the United States needs greater export for her trade balance. California-made color televisions will bring back U.S. dollars from overseas that we need to purchase oil. Our magnetic tape plant will also export over $60 million of videocassettes.

4. Why Penalize Sony San Diego?

Why does California penilize Sony for having selected this tate for $50 million capital investment and for creating job pportunities for 1,600 people? Why for our economic contribution o the State and to the United States, do we have to pay $1.5 million dditional tax out of our global income outside the United States? ony should be complimented upon by California rather than enalized. We resent this unitary tax on a worldwide basis.

5. Three-Factor Formula Creates Distortions When Applied on a Worldwide Basis.

The unitary concept was formulated as a mechanism to enable e states to equitably allocate income as between states in which e enterprise operates, normally upon the basis of the three-factor rmula of property, payroll, and sales. These factors are deemed be rough approximations in equal weight of the income-generating cets of the enterprise, and the societal burdens and benefits volved in connection therewith.

However, fundamental to the equitableness of the unitary ncept is the asssumption that all of the states have roughly mparable factors utilized in the denominator, therefore, the e of the three-factor formula arguably provides rough equity in portioning the total tax burden among the various states in which e enterprise operates.

When this unitary concept is translated into a worldwide concept, however, the equitable underpinnings of the concept fall. When applied on a worldwide basis, gross distortions are created through wide ranges of wage rates and productivity of labor, substantial differences in the cost of a plant, equipment, inventory, and other porperty and, further, through differing risk factors and rates of return, differing sales prices and practices, fluctuating conversion rates of currency, and even currency restrictions.

Sony Corporation encompasses about 50 worldwide consolidated companies in addition to about 70 non-consolidated subsidiaries and affiliates, many of which transact business completely unrealted to Sony Corporation of America and most in places with no connection with the United States.

Different places in the world, different management styles, different bookkeeping, different incentives, different tax systems, different fringe benefit systems, different risks and different risks and different pricing make the application of unitary tax on a worldwide basis most unreasonable and, if forced upon, it simply creates distortions and very often injustices like the case with us here.

6. Historical Book Values and Revenue Contributions

The historical cost of manufacturing equipment as between the newer, higher priced equipment located in our plant in San Diego as compared to worldwide costs of comparable equipment located elsewhere in the world has no logical relationship to profits earned.

similar equipment made in Japan a few years prior to the one in San Diego can have a better productivity due from complete debugging and experiences the workers have had with the equipment, thereby, making a greater revenue contribution. You cannot relate historical book values and revenue contributions among equipments of different age and locations in the world.

7. Life-time Employment

In Japan, employees enjoy lifetime tenure. This lifetime tenure system provides employees with security for building stable family life. Such lifetime employment has a great value and for that great value employees give special dedication to the company. The result is their greater contribution to the profit. Revenue contribution of lifetime employment is not expressed in payroll as such. Money is not all the value people work for. All these make the use of payroll factor misleading and highly dangerous.

8. Fringe Benefits Are Different

Japanese employees have fringe benefits different from other countries. For example, housing benefits have a very important value because of the shortage of houses and the extreme scarcity of land for housing. Most workers commute by trains from far away taking one and a half hours in the morning and in the evening in the famous crowded trains. Probably not many other countries have as difficult housing situation as Japan. This makes the housing benefit highly valuable and an important factor for revenue contribution. Dental coverage included in the usual health insurance in Japan has also a very important meaning for employees, particularly when compared to the United States. All these elements make reliance on payroll factors for revenue contribution unreasonable and impracticable. Efforts to remove distortion by adjustments would further complicate the method in vain. You cannot have complete worldwide details on pension payments, transportation allowances, severance payments, housing benefits, health insurance, retirement benefits and other related elements, particularly when all of these are changing year to year in so many countries where worldwide business takes place.

Efforts to make adjustments will fail and will surely distort the end result.

9. Start-up Costs at San Diego Plant

$1 million out of the over $1.5 million difference between worldwide basis and domestic basis demanded of Sony to pay additionally, comes from just those first three years of our start-up period at San Diego plant in 1972, 1973, and 1974.

The worldwide unitary approach by California is singularly inappropriate in view of this start-up situation that did exist at our San Diego plant in those years. The effect of unitary approach is to levy the heaviest tax burden just when start-up costs and losses are at a peak resulting in abnormally high cost (and low profits) in California just at the time when the numerator (and, thus, the portion of Sony's worldwide income subject to California tax) increases due to new investment and new employees. It must be remembered that the period, in which the San Diego plant and equipment were purchased, was highly inflationary while the capital assets in Japan and other parts of the world by and large, were not purchased during this highly inflationary period.

10. Currency Exchange Rate Fluctuated

The U.S. dollar-yen exchange rate has widely fluctuated since the end of the fixed rate of 360 yen to $1 in August, 1971. The yen kept growing stronger and the rate changed to 300 yen to $1 by the end of 1971 and then further to 253 yen to $1 in July, 1973. The exchange rate then gradually reversed its direction of change and the yen fell to about 300 yen to $1 level and stayed thereabout through 1974,1975, and 1976 till it began to rise again in February, 1977.

The yen kept rising in its value through 1977 and 1978 till it hit 176 yen to $1 and prompted the defense of the U.S. dollar by the Carter Administration in October, 1978. Exchange rates of other foreign currencies to the U.S. dollar or to the Japanese yen also fluctuated widely at different speeds and ranges. These exchange rates fluctuated widely year to year and certainly also within each year.

The exchange rate of the Japanese yen to the U.S. dollar in Tokyo for 1972, 1973, and 1974 at the end of each month were:

At the end of	1972	1973	1974
January	310.20	301.10	299.10
February	304.00	266.50	285.80
March	303.90	265.90	273.80
April	304.40	265.50	280.00
May	304.60	264.80	281.40
June	301.20	265.30	284.00
July	301.10	263.50	297.60
August	301.10	265.30	302.70
September	301.10	265.50	297.50
October	301.10	266.80	299.85
November	301.10	279.90	300.00
December	301.50	280.00	300.60

California Franchise Tax Board needs our property, payroll, and sales all expressed in the U.S. dollar and that means translation of various foreign currencies into the yen and then to the U.S. dollar. The question is what exchange rate to use. Should they be those at the beginning, the middle or the end of the year? If we are to convert Japanese property, payroll and sales of 1973 into U.S. dollar amounts, you would have three different exchange rates at those three different time points.

Should we use the exchange rate of the date of purchase of each property for the accuracy sake of the value of the properties rather than that of the last day of the year against the total historic value in yen of all properties purchased over the years? But such would be next to impossible in view of tremendous involvement in computations. But, the other approach would give a grossly wrong property factor. The same gross distortion creeps into payroll and sales factors unless monthly or, even better but far more difficult, daily rate is used to convert yen amounts to dollar amounts. Some years had less fluctation than other years as listed below.

Year	Fluctuation
1972	3%
1973	13%
1974	11%
1975	6%
1976	6%
1977	17%
1978	27%
1979	24%

Fluctuations were as high as 27 percent, 24 percent, 17 percent, 13 percent and 11 percent in the order of 1978, 1979, 1977, 1973, and 1974. In those years, factors may be distorted over 10 percent easily.

If an average exchange rate of the year is applied while a certain major property was purchased when the yen was the strongest against the U.S. dollar in the year, the U.S. dollar value of the property would look smaller than it really was, thereby, distorting the factor of property and, therefore, the income allocation according to the worldwide unitary tax system.

The yen-U.S. dollar exchange rate alone creates such an impossible problem in computing property, payroll, and sales factors for all those years. How many more complications there would be when one has to do fair and just treatment of those factors of international operations in U.K., Germany, France, Spain Switzerland, Brazil, Panama, Venezuela, Hong Kong, and many other countries of different currencies. When faced with such impossible task inherent in the worldwide unitary tax systems, should one use a convenient method, ignoring terrible distortions? The answer must be found in another taxing method than the unitary tax on a worldwide basis.

11. Our Capital Investments in Alabama and Other Areas Are Helping Us.

Not to repeat our bitter experience in tax, we went to Alabama for our second major capital investment in the U.S. It is now even larger than the one in California. In Alabama, we have over 1,200 employees with a $75 million investment in manufacturing video recording tapes in cassettes. Since we began our investment in Alabama, our exposure to California's unitary tax on a worldwide basis has improved. But as long as California and other states stay free to use the unitary tax on a worldwide basis and to subject to this unjustifiable tax, the income of the parent company and the parent's subsidiaries outside of the United States unrelated to the U.S. manufacturing, we feel very uncomfortable in making capital investment in these states. This is against the direction the United States and Japan must move in order to move forward.

12. Stop International Double Tax By Use of IRS Code Sec. 482

Our income outside the U.S. is taxed in each country, but the California Franchise Tax Board tries to subject such tax-paid income to the unitary tax on a worldwide basis. We would suffer, then, from such international double taxation. The Federal Government does not do this. According to the U.S.-Japan tax treaty, the U.S. Treasury does not in any way tax the worldwide income of Sony. The U.S. Treasury, with far more at stake, has agreed that the "arm's length" test is the only fair and workable approach and they have relied on the accepted and time-tested provisions of Section 482 of the IRS Code in dealing with Sony Corporation and Sony Corporation of America.

Sony strongly hopes the United States will stop California and other states from using the unitary tax on a worldwide basis.

13. Fair and Just Treatment of Tax Will Finally Prevail

On September 27, 1977, Governor Brown reversed his earlier position and threw his support behind the proposed U.S.-U.K. tax treaty which, had it been ratified in the original form with its Article 9 (4) intact, would have exempted U.K. multinational corporations from the California's worldwide unitary tax. This reversal came about when it became known that the cost of the U.S.-U.K. tax treaty to California would not be as expensive as was considered earlier, while its benefit in making California more attractive to foreign capital investment was growing important and desireable.

Governor Brown coauthored with Senator Alan Cranston the telegram to Senator John Sparkman, Chairman of the Senate Foreign Relations Committee, and urged the ratification of the treaty for the best interest of the State and the Nation. Dynamics of economics and politics are certainly important, but we can surely expect the spirit of fairness and justice to perform their act.

Unfortunately, the critical Article 9 (4) was reserved and the treaty was passed without it in the U.S. Senate. The efforts by Governor Brown, Senator Cranston, and many others to stop the worldwide unitary tax system through the U.S.-U.K. tax treaty failed but there are bills in the U.S. Senate and the House that would stop states from taxing on the worldwide unitary tax concept. The Senate Bill S.1688 introduced by Senator Charles McC. Mathias, Jr., and the House Bill H.R.5076 by Mr. Barber B. Conable, Jr., are signs of strong and rising interest in holding states and other local taxing authorities from taxing foreign income of foreign corporations by such an arbitrary and unfair method as the worldwide unitary tax. Sony is very pleased to be here in support of S.1688 and to see growing interest and increasing understanding in this subject. We believe fair and just treatment of tax will finally prevail by your support and your legislative action.

14. Legislative Activities in California

Even in the State of California itself, there has been a very active legislative process in prohibiting taxing foreign income of foreign parents of their subsidiaries operating in California. The Bill is California State Assembly Bill No. 525 (copy attached) and its SECTION 1 clearly acknowledges the problems that arise from their unitary tax on a worldwide basis.

SECTION 1 reads as follows:

> "The Legislature finds that generally accepted accounting methods in general use by foreign based taxpayers are materially different from accounting methods used by United States based taxpayers, and income statements prepared under foreign accounting standards are not readily converted to income statements based on the California Bank and Corporation Tax Law. The Legislature further finds that many unresolved problems have arisen in accounting for change in foreign exchange rates, both in determination of income and in constructing apportionment data of foreign based taxpayers, on a basis consistent with that used to determine income earned in California by United States taxpayers. The Legislature further finds that the cost burden of converting income statements of foreign based taxpayers to income statements more comparable to those of United States based taxpayers is often substantially greater than any resulting tax on income considered to be earned in California. The Legislature further finds that the inclusion of foreign income in determining the tax liability of foreign economic interests wishing to invest in California has frequently resulted in unfair taxation of foreign based taxpayers and consequently acted as an impairment to investment and hindered the creation of new opportunities for employment and the diversification of the economic base of this state."

The California State Bill, AB-525, has a good record in the California State Assembly and the State Senate. It passed the Assembly Revenue and Taxation Committee by 10 to 2, the Assembly Ways and Means Committee by 13 to 5, the Assembly Floor by 64 to 10, and the Senate Revenue and Taxation Committee by 6 to 0. It survived the test of California's Proposition 9 or so-called Jarvis II, which,had it been passed by the June 3rd ballot in California, would have killed the bill. Now, it is set for a hearing before the California State Senate Finance Committee on June 30th and the prospect is good.

15. Conclusion

The unitary tax on a worldwide basis forces upon subsidiaries of foreign parents many technical difficulties almost impossible to resolve because of different accounting systems, different customs, different incentives, different laws, and widely fluctuating values of different currencies. It imposes international double taxes. It penalizes those who minimize import from Japan to the United States by making major capital investments and by hiring hundreds and thousands of American employees.

In the State of California, where this tax system is used, the bill that acknowledges the fundamental problems and tries to correct it has received an overwhelming support of 93 to 17 in the combined votes to date. This is an encouraging sign.

Sony Corporation of America sincerely asks for your understanding of the problems and for your decision of wisdom and justice by supporting and passing the Senate Bill S. 1688. It will make the United States much more reasonable and attractive for capital investments. It will help create thousands and thousands more jobs. It will help improve the balance of trade by minimizing import.

Sony appreciates this opportunity to submit our statement. Thank you very much.

AMENDED IN SENATE MAY 22, 1980
AMENDED IN SENATE MAY 1, 1980
AMENDED IN SENATE MARCH 27, 1980
AMENDED IN ASSEMBLY JANUARY 28, 1980
AMENDED IN ASSEMBLY JANUARY 21, 1980
AMENDED IN ASSEMBLY SEPTEMBER 14, 1979
AMENDED IN ASSEMBLY MAY 16, 1979

CALIFORNIA LEGISLATURE—1979-80 REGULAR SESSION

ASSEMBLY BILL No. 525

Introduced by Assemblymen Hughes, Kapiloff, Imbrecht, Moore, Naylor, and Dennis Brown
(Principal coauthors: Assemblymen Mori and Deddeh)

February 12, 1979

REFERRED TO COMMITTEE ON REVENUE AND TAXATION

An act to add Section 25101.9 to the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 525, as amended, Hughes (Rev. & Tax.). Bank and Corporation Tax Law: unitary business.

Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state.

This bill would provide that in determining the income subject to tax of a bank, corporation, or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation or other entity, if such bank, corporation, or other entity is (1) created or organized under the laws of a foreign country, and (2) not owned and controlled by a United States corporation or residents of the United States.

Corporations engaged in the ~~energy business and the~~ steel business and a business owning agricultural land in this state are excepted from the provisions of the bill.

This bill would take effect immediately as a tax levy.

This bill would provide that if any provision of this act is held invalid, such invalidity shall not affect other provisions of the act which can be given effect without the invalid provision.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

SECTION 1. The Legislature finds that generally accepted accounting methods in general use by foreign based taxpayers are materially different from accounting methods used by United States based taxpayers, and income statements prepared under foreign accounting standards are not readily converted to income statements based on the California Bank and Corporation Tax Law. The Legislature further finds that many unresolved problems have arisen in accounting for changes in foreign exchange rates, both in determination of income and in constructing apportionment data of foreign based taxpayers, on a basis consistent with that used to determine income earned in California by United States taxpayers. The Legislature further finds that the cost burden of converting income statements of foreign based taxpayers to income statements more comparable to those of United States based taxpayers is often substantially greater than any resulting tax on income considered to be earned in California. The Legislature further finds that the inclusion of foreign income in determining the tax liability of foreign economic interests wishing to invest in California has frequently resulted in unfair taxation of foreign based taxpayers and consequently acted as an impairment to investment and hindered the creation of new opportunities for employment and the diversification of the economic base of this state.

~~SEC. 2. The Legislature further finds and declares that the energy business is not included under the provisions of this act as, in general, the entities that such businesses control are established by geographical and political boundaries, rather than functional operations, for purposes not related to basic economies of the market.~~

~~SEC. 3.~~

SEC. 2. Section 25101.9 is added to the Revenue and Taxation Code, to read:

25101.9. (a) Notwithstanding any other provision of this chapter (except as provided in subdivision (g)), in determining the income subject to tax of any bank, corporation, or other entity liable to report under this part, there shall not be taken into account the income or apportionment factors of any other bank, corporation, or other entity if such other bank, corporation, or other entity:

(1) Is created or organized under the laws of a foreign country; and

(2) Is not owned or controlled by a United States corporation or residents of the United States.

~~(b) For purposes of this section, the activities conducted within or directed from the United States by any bank, corporation, or other entity meeting the conditions set forth under paragraphs (1) and (2) of subdivision (a) shall be deemed to be conducted by a separate bank, corporation, or other entity which does not meet such conditions, and the income of any such bank, corporation, or other entity subject to allocation and apportionment under this chapter to determine its tax or the tax upon any other bank, corporation, or other entity liable to report under this part shall be limited to~~

~~and determined from, under regulations prescribed by the Franchise Tax Board, the books of account maintained by such bank, corporation or other entity with respect to such activities conducted within or directed from the United States.~~

(b) For purposes of this section, the activities conducted within or directed from the United States by any bank, corporation, or other entity meeting the conditions set forth under paragraphs (1) and (2) of subdivision (a) shall be deemed to be conducted by a separate bank, corporation, or other entity which does not meet such conditions, and, except as provided in subdivision (g), the income and apportionment factors of any such bank, corporation, or other entity shall be determined upon the basis of the books of account maintained by such bank or corporation or other entity with respect to the activities conducted within or directed from the United States and the income and apportionment factors with respect to such activities shall be taken into account in the manner authorized by this chapter.

(c) The Franchise Tax Board shall audit, at least once every four years, the separate accounting and arm's length transactions of any bank, corporation, or other entity determining income pursuant to this section.

(d) This section shall not apply in determining the income allocable to this state from a unitary business whose principal activity is ~~the energy business,~~ the steel business, or a business owning agricultural land in this state. ~~For the purpose of this subdivision, the term "energy business" means operations pertaining to the obtaining, processing, or marketing of a source of energy, including exploring, discovering, developing, mining, drilling, processing, manufacturing, treating, transporting, refining, producing, acquiring, managing, marketing, or researching in connection with any energy source such as coal, oil, petroleum products, natural gas, and uranium, but does not mean operations pertaining to the following alternative energy sources: solar, geothermal, coal gasification, wind, biomass, and~~

~~photovoltaic.~~ For the purpose of this subdivision, the term "steel business" means the manufacture or sale of products rolled, formed, shaped, drawn, extruded, forged, cast, fabricated, or otherwise similarly processed, or processed by a combination of two or more of such operations, from steel made by the open hearth, basic oxygen, electric furnace, Bessemer, or other steelmaking process. For purposes of this section, "agricultural land" is land used for the production of agricultural commodities for commercial purposes.

(e) For purposes of this section, direct or indirect ownership or control of more than 50 percent of the voting stock shall constitute ownership or control.

(f) The following definitions shall apply for the purposes of this section:

(1) The term "residents of the United States" means residents of the United States, its territories, or possessions, or the Commonwealth of Puerto Rico.

(2) The term "United States corporation" means a bank, corporation, or other entity organized under the laws of the United States, its political subdivisions, its territories, or possessions, or the Commonwealth of Puerto Rico.

(g) Nothing in this section shall preclude the Franchise Tax Board from distributing, apportioning, or allocating gross income, deductions, credits, or allowances between or among organizations, trades, or businesses, if it determines that it is necessary to do so in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

~~(h) In view of pending litigation concerning the proper treatment of intercompany dividends, it is not intended by enactment of this act that any inference be drawn from it in such litigation.~~

(h) In view of pending litigation concerning the question of whether a corporation liable to report under the Bank and Corporation Tax Law must take into account the income and apportionment factors of other corporations operating in a foreign country, it is not intended that any inference be drawn from the

enactment of this act in any litigation concerning such question.

~~SEC. 4.~~

SEC. 3. This act shall not be effective for income years beginning on or after January 1, 1980, if an initiative constitutional amendment to limit state income tax rates to one-half, which is on the June 1980, ballot, is approved by the voters.

~~SEC. 4.5.~~

SEC. 4. The Legislative Analyst shall report to the Legislature during the 1988 legislative session on the impact of this act.

SEC. 5. This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect. However, the provisions of this act shall apply in the computation of taxes for income years beginning on orafter January 1, 1980.

~~SEC. 6. If any provision of this act or the application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to this end the provisions of this act are severable.~~

SEC. 6. If any provision of this act or the application thereof to any person or circumstance is held invalid or unconstitutional because it favors foreign-based corporate entities over domestic-based corporate entities or for any other reason, then this act shall be invalid in its entirety and shall be repealed.

Summary of Written
Statement of Roger Kirk
Vice-Chairman of the Board
Brown & Williamson Tobacco Corporation

Mr. Chairman, Members of the Subcommittee, I am Roger Kirk, Vice-Chairman of the Board of Brown & Williamson Tobacco Corporation which manufactures tobacco products. It is a subsidiary of BATUS, Inc., which is owned by BAT Industries, Ltd., a United Kingdom corporation. BAT is England's third largest industrial, and employs more than 250,000 persons on six continents. It is involved in five separate and unrelated lines of business, tobacco, paper, retailing, cosmetics, and packaging.

BAT is joined in its support of S. 1688 by the "Unitary Tax Campaign" composed of the major English companies having U.S. affiliates and which have invested in this country and employ its citizens. I have been asked to forward its written statement for the record, which I will deliver to the Committee on Finance staff.

Some have alleged that this legislation creates a preference for foreign corporations. I would draw the Subcommittee's attention for an explanation that that is not the case to the remarks of John S. Nolan, Counsel on behalf of the Confederation of British Industry at the March 31, 1980, hearing before the Committee on Ways and Means on this bill's House counterpart, H.R. 5076.

In summary of my written statement I would like to outline the basis of our support for this legislation which would limit the use of the worldwide combined reporting system method of corporate tax assessment. I should point out that its use by California, its leading exponent among the few individual States that do use it, has resulted in substantial savings in BAT's case.

California requires that profits be assigned to it by use of a three factor formula utilizing sales, property and payroll. The sum of those factors in California over those factors worldwide results in a percentage, which applied to worldwide income theoretically produces the proper amount of income "earned" in California. For that formula to produce equitable results it is essential that the factors be equal throughout the taxed corporation's operations and those with which it is combined, and that those operations be related.

Though California has combined operations of distinctly unrelated affiliated corporations, in our case no attempt has been made to combine domestic or international non-tobacco operations of BAT worldwide. Since 1968, when the California Franchise Tax Board first required Brown & Williamson to submit combined worldwide reports, its tax has amounted to about $2,800,000. If tax had been computed without regard to the worldwide activity of its foreign parent, it would have been $3,700,000, mainly because Brown & Williamson is relatively more profitable using lower invested capital than is generally true for the worldwide group.

In our case, the California Franchise Tax Board used an arbitrary basis because of the difficulty of rewriting reports from the seventy countries in which BAT's companies do business. This arbitrary basis did not produce the correct tax, but satisfied the Franchise Tax Board because it felt it was awarding the lowest possible tax refund.

This experience reinforces our view regarding the resulting tax partiality. If the law requires full combination of worldwide activities, then the Franchise Tax Board acts unfairly towards BAT, or other tax payers as the case may be, when it favors expediency over legal requirements.

If the use of the worldwide combined reporting system has worked to our financial benefit, why do we support S. 1688, which would return us to the threat of higher taxes in California? Because the use of the worldwide combined reporting system is so totally unjust that we prefer the old basis of assessment notwithstanding the additional tax burden.

Combining worldwide and often unrelated lines of business does not take into account often quite different factors. California wages are significantly higher than labor rates of most countries, which vary widely. As long as this disparity is present, the payroll factor of the three factor formula will always produce distortions to the State's benefit.

Currency rates can cause distortion. California, for example, makes no allowance for the fact that some currencies are not practically convertible into U.S. equivalents, or that many countries, particularly those in the Third World, restrict or even bar transfer of funds.

Distortion can also result due to the wide international variance of import duties and excise and sales taxes. Those taxes are included in the costs of sales which, when combined, can cause distortion due to their wide range.

Being part of a worldwide group of companies operating in differing and unrelated lines of business, we are concerned about proliferation of the worldwide combined reporting system. Countries whose corporations are being abused by its use could develop retaliatory measures. Unscrupulous foreign government authorities could use the system to impose confiscatory taxation under the cloak of respectability.

The Federal Government has recently agreed in a tax treaty with the United Kingdom not to utilize the worldwide combined reporting system. Given that recognition of the need to limit the use of the worldwide combined reporting system, S. 1688 should be enacted. It would eliminate the abuses of the current use of the system by a few individual States and prevent its proliferation. It would provide consistency and uniformity in the taxation of international commerce, and spur investment and the creation of employment opportunities in this country.

Thank you.

Written Statement of

ROGER KIRK,

Vice-Chairman of the Board,

Brown & Williamson Tobacco Corporation,

Mr. Chairman, Members of the Committee, I am Roger Kirk, Vice-Chairman of the Board of Brown & Williamson Tobacco Corporation, 2000 Citizens Plaza, Louisville, Kentucky, 40202. Brown and Williamson manufactures tobacco products. It is owned by BATUS, Inc., which is owned by BAT Industries, Ltd., a United Kingdom corporation. BAT is Britain's third largest industrial, employing more than 250,000 persons on six continents. It is involved in five separate and unrelated lines of business: tobacco, paper, retailing, cosmetics, and packaging.

I would like to outline the reasons why S. 1688, which would limit the use of the worldwide combined reporting system method of corporate tax assessment and establish a uniform method of taxation by the States of foreign source dividends, should be enacted. U.S. corporations with foreign parents are not effected by the second portion of the bill.

S. 1688 would conform the State rules to those of the Federal Government in two very specific areas: the time at which states tax the foreign source income of foreign affiliates, and the quantity of foreign source dividends which are taxed. The legislation would accomplish those slight limitations by establishing that a State may not take into account or include in income subject to tax the income of any foreign corporation in any year prior to the year in such which income is included in income subject to tax by the Federal Government. In other words, the foreign source income of a foreign subsidiary of a U.S. parent corporation would be taxed only, if, and to the extent, paid back to the U.S. as a dividend, or deemed paid back by application of Subpart F of the Internal Revenue Code. Since the Federal Government does not tax income of a foreign parent from a U.S. subsidiary, that income would not be taxed. Of course, the U.S. subsidiary would already have paid taxes on its income at both the State and Federal levels. Some have depicted this situation as a "preference for foreign corporations." That is not the case.

In the case of dividends received by a U.S. parent from a foreign subsidiary, the bill would permit a State to tax no greater portion of that dividend than the Federal Government effectively taxes. This would not eliminate all state taxation of foreign source dividends. It would eliminate double taxation of those dividends by permitting the States to tax, at whatever rate they apply to other income, only that portion of foreign source dividends which the Federal Government effectively taxes after taking into account the foreign tax credit.

All States having a corporate income tax use some form of apportionment to determine the tax liability of the unitary, related operations of a single, multi-state corporation. A State typically uses its formula to apportion income:

> ...on the basis of a weighted or simple average of the percentages that such factors as payroll, property, and sales within the state bear to the total amounts of these factors [in all states.] Carlson, State Taxation of Corporate Income from Foreign Sources, in TAX POLICY RESEARCH STUDY: NO 3, ESSAYS IN INTERNATIONAL TAXATION: 1976, 231, 242 (Department of the Treasury, Washington, D.C.) (1976)

A substantial number of States extend the concept of formula apportionment to a controlled group of corporations when the operations and management are "unitary" in character, i.e., integrated to accomplish a single business purpose or related business purposes. Those States which apply formula apportionment to the unitary operations of related corporations are said to employ the "unitary apportionment system" of tax assessment.

A few States, and only California consistently, have extended the application of unitary apportionment to the international operations of foreign subsidiaries and foreign parents of domestic corporations, regardless of whether the activities of those affilated corporations were related or "unitary." It is this method of tax assessment that has become known as the worldwide combined reporting system.

The late Laurence N. Woodworth, then Assistant Secretary of the Treasury, described that system as used by California in a prepared statement submitted to the Senate Committee on Foreign Relations on July 19, 1977:

> [When] an enterprise doing business in California controls other corporations, is itself controlled by another corporation, or is related to other corporations by virtue of common ownership, and when the degree of common ownership or control is over 50 percent, California requires the controlled group to file a combined report of the group's worldwide income.
>
> California tax authorities appear to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must be included in a combined report to the tax authorities.
>
> The combined report is, in effect, a consolidated return of the controlled group's worldwide income, although seperate returns may be made for each member of the group. Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, hearings before the U.S. Senate Committee on Foreign Relations, 1st Session, 95th Congress, Statement of Laurence N. Woodworth, (1977), pp. 32-33.

As used by California, the worldwide combined reporting system requires that profits be assigned to it by use of a three factor formula utilizing sales, property and payroll. The sum of those factors in California over those factors worldwide results in a percentage, which applied to worldwide income theoretically produces the proper amount of income "earned" in California. For that formula to produce equitable results it is necessary that the factors be equal throughout the taxed corporation's operations, and a related line of business which is being combined.

In administering the Federal tax laws, the Internal Revenue Service has adopted the arm's length standard for apportioning income between related domestic and foreign corporations. The regulations implementing IRC section 482 could not be more straightforward:

> (b) Scope and Purpose. The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer the true taxable income from the property and business of a controlled taxpayer.*** 26 C.F.R. section 1.482-1(b)

For the purpose of the Internal Revenue Code:

> (6) the term "true taxable income" means, in the case of a controlled taxpayer,

> the taxable income which would have resulted to the controlled taxpayer, had it in the conduct of its affairs *** dealt with the other member or members of the group at arm's length. 26 C.F.R. Section 1.482-1(a)(6)

Though California has combined operations of affiliated corporations that are distinctly unrelated, no attempt has been made to combine domestic or international non-tobacco operations of BAT worldwide. In our case, this has produced considerable savings. Since 1968, when the California Franchise Tax Board first required Brown & Williamson to submit combined worldwide reports, its tax has amounted to about $2,800,000. If tax had been computed without regard to the worldwide activity of its foreign parent, it would have been $3,700,000. This is largely because Brown & Williamson is relatively more profitable using lower invested capital than is generally true for the worldwide group.

Also, our administrative burden has not been too great in complying with California's demands. The Franchise Tax Board does not, except in no more than a handful of cases, enforce the usual requirement causing groups domiciled abroad to rewrite financial reports to accord with California tax principles. In our case, the Franchise Tax Board has utilized an arbitrary basis because of the considerable difficulty in rewriting reports from the seventy countries in which BAT's subsidiaries do business. Though this arbitrary basis does not achieve the correct tax, the Franchise Board has been satisfied because it knows it is awarding the lowest possible tax refund. This experience reinforces oura view regarding the resulting tax partiality. If the law requires full combination of worldwide activities, then the Franchise Tax Board acts unfairly towards BAT, or other taxpayers, as the case may be, when it favors expediency over legal requirements.

Why do we support S. 1688, which would limit the use of that method and return us to the threat of higher taxes in California? Because we regard the use of the worldwide combined reporting system to be so totally unjust that we prefer the old basis of assessment notwithstanding the additional tax burden.

The application of the worldwide combined reporting system causes a number of problems. The United States Government and virtually all other governments in the world determine taxable income on the basis of what are arm's length transactions between related companies. The use of a different method by one jurisdiction often leads to double taxation. The Organization for Economic Cooperation and Development , of which the U.S. is a member, has included the arm's length standard in its Model Income Tax Convention. The 1974 Guidelines for Tax Treaties Between Developed and Undeveloped

Countries, prepared under the auspices of the United Nations, adopts the same principle.

Compliance with the system requires elaborate recordkeeping by corporations. Being forced to combine worldwide does not take into account the ill effects of attempting to combine differing accounting principles. For example, California also has its own system of determining depreciation. It would be an extreme burden for corporations already complying with foreign depreciation requirements to recast their entire depreciation system to adopt California's.

Labor rates vary widely internationally. California wages are significantly higher than most of the world. As long as this disparity exists, the payroll factor of California's formula will always produce distortions to its benefit.

The assumption that profit rates in different units of a corporate family engaged in different activities in different locations are always the same is implicit in the use of the system. That this is seldom the case causes income to be misallocated.

When attempting to combine different and often unrelated lines of business in which the worldwide affiliates of corporations are engaged, distortion can be caused by different currency exchange rates. Some currencies are not practically convertible into U.S. equivalents. Many countries, particulary those in the Third World, restrict or even bar transfer of funds. California makes no allowance for this factor.

Having considered the abuses to which the use of the worldwide combined reporting system subjects corporations which have affiliates in more than one country, the International Chamber of Commerce issued the following resolution on September 26, 1979:

> The ICC views with concern the inevitability that an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations, will result in mounting double taxation of profits (which tax treaties set out to avoid). This is particulary so if the basis of assessment in any such political sub-division is not entirely consistent with that of the country itself and extends to operations carried on outside the country. This problem has manifested itself in an acute form in connection with the attempts of the State of California to impose the "global" or "unitary" form of assessment based on income of companies involved in international operations outside the U.S.
>
> The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would have been otherwise undertaken. This approach, if it should spread, could easily become a most important

> threat to international trade since international operations would inevitably be confronted with a real danger of multiple taxation of the same profits and unacceptable administrative burdens. The dangers were also recognized by the Council of the OECD in rejecting the so-called "global" method in its recent report on Transfer Pricing (Transfer Pricing and Multinational Enterprises (OECD, Paris, July, 1979) pp 14-15.
>
> The ICC reconfirms its view that, as a general rule, tax should be based on a fair measure of income as computed by reference to the amount which could be expected to arise between independent parties dealing at arm's length. This rule has universal application. The ICC recommends that, in all cases where the taxation policies of political sub-divisions extend to non-domestic operations, all possible measures should be taken to ensure that the terms of an agreement or treaty dealing with taxation on income should bind all authorities having jurisdiction within the boundaries of each contracting State. This recommendation is in accordance with the OECD Model Taxation Convention, 1977 (Art. 2.) and a considerable numberd of international friendship, trade and shipping treaties.

The Supreme Court of the United States has recently considered taxation of states which lead to multiple taxation and taxation of foreign source income. In Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, (1979) the Court expressed the need to avoid multiple taxation and to insure that the United States speaks with one voice in matters of foreign, rather than interstate, commerce.

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On March 19, 1980, the United States Supreme Court decided Mobil Oil Corporation v. Commissioner of Taxes of Vermont., U.S. Supreme Court No. 78-1201. That case involved constitutional limits on a non-domiciliary State's taxation of income received by a domestic corporation in the form of dividends from subsidiaries and affiliates engaged in a related business abroad. Vermont makes no effort to extend unitary apportionment to business operations of foreign corporations through worldwide combined reporting. Vermont simply applies its formula -- based on property, payroll and sales -- to the "taxable income of the taxpayer... under the laws of the United States...." Mobil Oil Corporation v. Commissioner of Taxes of Vermont, U.S. Supreme Court, No. 78-1201, (March 19, 1980) at Slip Opinion 3. Therefore, Vermont, as most States, has incorporated by reference the arm's length standard for apportioning income between related domestic and foreign corporations.

In Mobil, the Court made it clear that:

> the linchpin of apportionability in the field of state income taxation is the unitary business principle." Slip Opinion 13.

It also clarified that its decision did not mean that:

> * * * all dividend income received by corporations operating in interstate

> commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. Slip Opinion 15.

The Court after acknowledging the lack of uniformity between states as to taxation of foreign source dividends said:

> Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so." Slip Opinion 22-23.

The United States Congress has also recently considered the problems caused by the use of the worldwide combined reporting system. In the House of Representatives Committee on Ways and Means, a Task Force on Foreign Source Income was formed to study five areas involving the taxation of foreign source income and to report to the Committee its recommendations. The Recommendations of the Task Force regarding state taxation of foreign source income were as follows:

> 1. Income of foreign affiliates not subject to Federal income tax.- It is recommended that the States be precluded from taking into account, under the unitary or any method, the income of foreign affiliates of corporations doing business within the States

> until such time as that income is subject to Federal income tax.
>
> 2. Income of foreign affiliates subject to Federal income tax.- It is further recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income becomes subject to Federal income tax. Committee on Ways and Means, U.S. House of Representatives, Recommendations of the Task Force on Foreign Source Income, Committee Print, 95th Congress, 1st Session. page 30.

In the United States Senate the Committee on Foreign Relations has most recently considered the worldwide combined reporting system. In its report on the Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Executive Q, 96th Congress, 1st Session, (June 15, 1979), the Committee said:

> During last year's debate both in the Foreign Relations Committee and on the Senate floor, opponents of Article 9(4) argued that any prohibition of the right of the states to use worldwide combination under the unitary tax system should be addressed legislatively rather than through the treaty process. Even some supporters of Article 9(4), while not questioning the propriety of the Article, indicated their preference for Congressional consideration through the legislative process of the issue. Report of the Committee on Foreign Relations, United States Senate, on Executive Q, 1st Session, 96th Congress), June 15, 1979, p. 6.

At that time, the Senate Committee on Foreign Relations was aware of the existence of S. 983 which had been previously introduced by Senator Charles McC. Mathias. One provision in that bill would impose a limitation on the use of the worldwide combined reporting system. On August 2 and 3, 1979, legislation specifically addressing the use of that system (S. 1688), and an indentical bill (H. R. 5076), were introduced in the Senate and House of Representatives respectively. In speaking of S. 983 and its limitation on the use of the worldwide combined reporting system, the Senate Committee on Foreign Relations report stated:

> The Committee urges the tax-writing Committees of the Congress--the Finance and the Ways and Means Committees--to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the issue. Report of the Committee on Foreign Relations, United States Senate, on Executive Q, 1st Session, 96th Congress, (June 15, 1979), p. 6.

Thus, all three branches of the Federal Government have recognized the need to impose limitations upon the use of the worldwide combined reporting system: the Executive branch through the Department of Treasury in its treaty negotiations

and the Internal Revenue Service through its regulations; the Judicial branch through the decisions of the Supreme Court of the United States; and the House of Representatives and the Senate of the Legislative branch as lastly described.

The Federal Government having so recognized the need to limit the use of the worlwide combined reporting system, S. 1688 should be enacted to comply with that need. Enactment of the legislation will not only eliminate the current abuses of the worldwide combined reporting system and prevent its proliferation, but will also provide consistency and uniformity in the taxation of international commerce.

Thank You.

The committee will stand in recess, it now being 12:55.

[Whereupon, at 12:55 p.m., the committee was adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record and will be found in part 2:]

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